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LONG-TERM STATUS OF THE SOCIAL SECURITY TRUST FUNDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SOCIAL SECURITY AND FAMILY POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

NEW YORK, NY,
JUNE 30, 1988

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LONG-TERM STATUS OF THE SOCIAL SECURITY TRUST FUNDS

THURSDAY, JUNE 30, 1988

U.S. SENATE,
SUBCOMMITTEE ON SOCIAL SECURITY
AND FAMILY POLICY,
COMMITTEE ON FINANCE,
New York, NY.

The Subcommittee met, pursuant to notice, at 10:02 a.m. in the Ceremonial Courtroom, Court of International Trade, 1 Federal Plaza, New York, New York, Hon. Daniel Patrick Moynihan presiding.

Present: Senator Moynihan.

The press release follows:]

[Press Release No. H-26]

FINANCE SUBCOMMITTEE TO HOLD FIELD HEARING ON SOCIAL SECURITY TRUST FUNDS

WASHINGTON, DC.—Senator Daniel P. Moynihan, (D., New York), Chairman of the Senate Finance Subcommittee on Social Security and Family Policy, announced today that the Subcommittee will hold a field hearing in New York on the financial implications of building up a projected $12 trillion OASDI trust fund reserve.

The hearing is scheduled for Thursday, June 30, 1988 at 10 a.m. in the Ceremonial Courtroom, Court of International Trade, 1 Federal Plaza, New York, New York.

In announcing the hearing, Moynihan said, "How do we save the Social Security surplus? Should we take the trust funds off budget, to preserve them from financing the deficit? Treasury Secretary Baker, for whom we have the greatest respect, has suggested we should not. This, of course, runs contrary to the arrangements in present law under which the trust funds will come off budget in 1994."

The hearings will focus on whether the trust funds should be off-budget, how trust fund assets should be invested, and how the investment options would affect private investment and aggregate savings.

Witnesses for this hearing will appear by invitation only.

[The prepared statement of Senator Moynihan appears in the appendix.]

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM THE STATE OF NEW YORK, CHAIRMAN OF THE SUBCOMMITTEE

Senator MOYNIHAN. A very good morning to our very select company of witnesses and such occasional spectators who may appear. This is the third in a series of hearings which the Subcommittee on Social Security and Family Policy of the Committee on Finance has been holding on the condition or the state of the Social Security trust fund reserves.

We have found that what began as a simple oversight exercise has expanded into something of an event in Washington and in-

creasingly so here in New York as it has finally come to be realized that the decisions made in that very brief and intense negotiation in January 1983 have put in place the most powerful revenue stream in the history of public finance in the United States.

Just yesterday, in the Washington Post, on the Op-Ed page, was an article of Professor Alan Blinder of Princeton. He is just the most recent academic to discover the fact of the building trust fund reserves. He put it in his opening sentence, "The secret is out."

A point I would wish to make is that if it was a secret to the Economics Department at Princeton, it was no secret to those of us who wrote the legislation. Senator Dole and I began this discussion on January 3 on the Senate floor and picked it up the next day. The day after that, Barber Conable, now has at the World Bank joined us. We were whisked down to the residence of the then chief of staff of the White House, Mr. James Baker, now Secretary of Treasury. We met in his house several evenings, and then moved the negotiations to the Blair House, which was closed for renovations, and therefore open for more or less private discussions. It took us 12 days to do what we did, and what we did was to move the Social Security Program from a pay-as-you-go basis to a partially funded system.

We used to maintain trust fund levels so that they would be just enough to get through. We wanted to be able to bring in enough to pay out what was owed with a reserve that would take into account the fluctuations in the economy, a recession. And this was in keeping with the general economic notion of the time, the Keynesian notion that there was a tendency to oversave in our economy.

I am old enough to remember the years in Washington in the Kennedy Administration when we were afflicted by a dread malady called fiscal drag, which is that the Federal government just couldn't manage to spend as much money as it took in, and it kept depressing the economy.

The notion of the Federal government accumulating large reserves was not one that the economists of the time would have thought a useful one. But this malady, it seems, has cured itself. Economists now say that the increased savings represented by government surpluses would be good for the economy. So this was an important consideration.

In our deliberations we were dealing with two major problems. The first was that the trust funds were losing money. This was primarily because prices had been rising faster than wages in the late 1970s, for the first time since World War II. That meant that payments going out of the system were running ahead of payments into it, and there was going to be a problem. Not the kind of problem David Stockman described when he said, in 1981, that "the most devastating bankruptcy in history" was months away. But that was part of the second problem, which was that there was just no confidence in the system.

To this day, the majority of non-retired adults in this country don't think they will get any Social Security or all that they are entitled to. It was possible for people who were hostile to the system, as Mr. Stockman was, to say, "bankrupt" and to be believed. A Reagan administration effort to cut back the program very sharply was stopped on the Senate floor. It was a combination of myself and Senator Dole. I was then ranking member of the Sub-

committee. He was Chairman of Finance. We both, then, with Howard Baker, Chief of Staff, as Majority Leader, proposed the Commission that was chaired by that very able New Yorker, now chairman of the Federal Reserve Board, Mr. Alan Greenspan, which Commission spent a year setting out the facts for Senators and others who really didn't know much about the program but had been hearing how badly off it was for a generation.

So we decided to go to a major infusion of funds, to strengthen financing and to restore or establish a measure of confidence in Social Security, and to increase savings.

We knew that the United States had a severe problem in the its savings rates and that it was going to have a worse one as we accumulated huge budget deficits in the Federal government in this decade; the government would triple the national debt. A fair amount of it would go overseas. That would have to be restored somehow.

We saw the savings inherent in a strong flow of funds into the Social Security trust funds as a way to restore the imbalance of this decade. And the discovery of that savings stream and its potential has, I think, aroused considerable interest here in New York in financial circles, and we are going to hear from some of the economists and financial advisers who are among those who have expressed their interest.

May I first, before we call our distinguished first panel, introduce my colleagues, which I ought to have done first, and I apologize that I did not. On my left, your right, is Mr. Andrew Samet, an attorney, a man of endless capacities in matters financial and fiscal who is advising me as a member of the National Economic Commission, and this is very much in our side track, how to deal with this matter. To my right, Mr. Eduard Lopez, who is a career officer of the Social Security Administration spending the year in our office. Mr. Lopez is an adviser of complete political neutrality but extraordinary ability and capability, and he puts up with us with a degree of patience that only the career civil servant has got to learn.

So to our affairs. May I first place in the record a very fine statement which I hope all the witnesses will have by Stephen J. Entin, who is the Deputy Assistant Secretary for Economic Policy of the Department of the Treasury. Mr. Entin has given us a thorough review of the funds from the point of view of the Treasury. It is the best piece of work I have seen, and it marks the beginning of some interest in this subject on the part of the Treasury, which I think is the counterpart of the interest here in the financial community in New York.

With that, and a statement I have which I will place in the record, we introduce our first panel, the first of three, and that will be Mr. Monte Gordon, who is Vice President and Director of Research of the Dreyfus Corporation; Mr. Neal Soss, who is Chief Economist and Managing Director of the First Boston Corp. , and Ms. Zwen Goy, who is the Assistant Vice President and Economist with the First Boston Corporation.

Would you all come forward and be seated, please.

May I just say to our witnesses that the purpose of this hearing is to establish a record. We want to know what you think we should know. I would say that if you have prepared papers, you can

read them if you like, but you might find it more useful to have the paper included in the record and then summarized by you so that we can get through your main points in fairly direct order. Then we can have some exchange between the chair and the panel and among yourselves.

I hope you will feel free to comment on what each other says, and so we begin. Mr. Gordon, good morning and welcome.

STATEMENT OF MONTE J. GORDON, VICE PRESIDENT AND DIRECTOR OF RESEARCH, DREYFUS CORP., NEW YORK, NY

Mr. GORDON. Okay. Good morning. Thank you for inviting me. The unmistakable position that we have is that this is a very significant new factor that has been entered into the financial picture. We think it was a very effective move, and we congratulate the Commission for having come up with it.

We think and what we have found is that one of the critical hints is a deep well of skepticism amongst people that I have talked to and others that we have talked with, small investors and others who participate in our funds, that that fund will be maintained intact.

There is always a strong suspicion, a strong underlying current that somehow, Congress and/or the Administration, singly or together, will come up and in some way reduce what is now actuarially forecast as far as that fund is concerned. I think that one of the most important points, therefore, is to indicate in some way that the integrity of the fund would be maintained.

Now, you get another factor that comes into that picture. You have created a pool of money that is a very significant pool, and as you indicated in your remarks, moves in the direction of increasing the savings propensity in the United States economy, which has been one of the difficult points that we have experienced over the last few years, and that is the absence of an adequate level of savings.

Should the money market, and it will begin to take perception of the presence of this fund, recognize or see in this fund some action by either the Congress or the Administration to reduce it or in some way to use it for purposes other than what it was originally intended for, then the markets will respond in very unmistakable terms, and what you will see, in all likelihood, is a declining price of long-term securities, particularly in the fixed-income area, which is, interestingly enough, widely held by the substantial segment of the population, so that you are impacting people's savings directly, because that is where the interest we see coming now is coming, in the fixed-income area.

The market will respond to anything that looks like that is being tampered with with some sense of showing its displeasure, and that is the main way in which it develops that, obviously, is to come down and lower the price of the securities, because that is the way the market expresses its sense of unease.

Senator MOYNIHAN. I am going to take the liberty——

Mr. GORDON. I'm sorry?

Senator MOYNIHAN. I am going to take the liberty of interrupting where I don't understand or would like to see a point more clearly. Is that basically in anticipation of inflation?

Mr. GORDON. Yes. That was just the point I was going to make.

Senator MOYNIHAN. All right.

Mr. GORDON. Because what you have created here in a real sense is a bulwark against the inflation pressure in a different way by putting the fund in a position where it can substantially alleviate the problem of the U.S. government seeking to finance in the open market. Whether it is financing huge deficits or simply an on-going budget, you have, in effect, released resources for private industry to employ, to develop, at lower costs because we would anticipate that as a consequence of the action and the result of this fund being present, we will see lower interest rates.

If you see that, and industry becomes more interested, then, and more capable of financing for the purpose of expanding production and expanding facilities and making it more efficient, then you have developed a fairly or I would suspect what is a rather strong bulwark against the inflationary pressures.

This is something that has great meaning in another sense: There has been an enormous leverage built in the U.S. economy as a consequence of building debt. Our structure caters in that way, and it encourages it. It has been one of the critical points to look at the impact of trying to reduce the budget deficit and try to bring down the trade deficit.

The presence of a lower interest cost and the presence of other similar factors as far as the pressure against inflation is concerned could well encourage American industry to employ equity as a source of financing to a greater degree and thereby reduce the level or at least point in the direction of reducing the leverage of the U.S. economy in terms of its corporate form.

So you would have a stronger economy. The other last point about that in a very real sense is the U.S. continues to have leadership in the industrialized world, for whatever it may be, and lower costs here, lower interest costs in the sense of productivity growth and so on will probably encourage other countries to reduce their costs in a similar way. A very significant effect could be developed in the ability of the rest of the world to develop their facilities to improve the standard of living in their particular area.

This is, in effect, whether you lucked into it or not, whether you intended it to be that election, you have injected a factor tore of very substantial proportions into the economy. This is only now beginning to pervade the consciousness of the financial community. It is not something that they look at and say, "Well, it is going to happen tomorrow," but the numbers are beginning to come around, and people are beginning to think, and as I say, the most critical point that we would urge is that care be taken in terms of dealing with it, as is a deep well of skepticism that the fund will be allowed to progress and be allowed to move without being impaired by the efforts of a Congress or administration.

That would be the end of my statement.

Senator MOYNIHAN. Mr. Gordon, you did have a written statement, and that will be placed in the record.

Mr. GORDON. Thank you.

[The prepared statement of Monte Gordon appears in the appendix.]

Senator MOYNIHAN. The first time I spoke about this prospect was at a commencement address in Utica College in Syracuse University in Utica, upstate, and I was speaking to a graduating class

and saying there is every reason to think there are going to be good economic times. We are going to have a pool of savings, and if you think that we are coming out of the eighties as a debtor nation and so forth, that is true, but there is this other aspect. And it happened that that weekend, a dear friend, John Westergaard, who is—obviously, you know his name—who is an economic——

Mr. GORDON. I gave him his first interview.

Senator MOYNIHAN. You did?

Mr. GORDON. I gave him his first interview on Wall Street.

Senator MOYNIHAN. I see. Well, is that correct?

Mr. GORDON. Yes.

Senator MOYNIHAN. He is a very dear friend, and he was just going along with an upstate tour, and he was sitting in the bleachers of this basketball court and afterwards, we got the car and he said, "My God, what did you say?" He said, "That is the makings of the bull market of the 1990s," and did I not hear you say bull market?

Mr. GORDON. No, you didn't hear me use that expression in that derivation, but most assuredly, if you create an environment where interest rates are going to come down and corporations are going to improve their equitable position, you clearly have set the stage for a very significant and basic improvement in the stock market over a period of time.

Senator MOYNIHAN. That is what he said. And if you waste it, well, then you won't; you will get the opposite.

Mr. GORDON. Absolutely.

Senator MOYNIHAN. So we are at one of those decision trades—isn't that what they say—one of those forks where you go one way or the other. And how we create this confidence, I don't know. I think I do know that the first thing is to bring this whole set of propositions up and say, as you did, that there is a choice to be made here.

Mr. GORDON. Yes.

Senator MOYNIHAN. And let us not think that, if you know that, then no one can interrupt. We can't look back and say, "Why didn't anyone tell us?"

Mr. GORDON. You see, it is a feeling. We have seen this before, and you have seen this kind of thing tried, and then it is broken down and it doesn't quite work and the Congress moves in one direction or another. Just a point: You had it for years with the Federal Reserve Board, which lacked credibility, until it held to its position in the seventies and through the eighties, and finally moved in position so that people accepted what they said. You have established something here which is very critical.

I might mention one other point. It is very much in keeping with the demographics as far as the United States is concerned, because the aging of the United States or the graying of America, as the saying goes, has been a deep-seated fear that there would not be enough money there in the Social Security trust fund to take care of people.

Senator MOYNIHAN. Yes. If I could say, and I don't want to intrude on other people's time, and we have plenty—if you have plenty of time, I have plenty of time. Two things in that regard. The first is that Social Security expenditures are declining as a

percentage of payroll, not rising; and second, in terms of the two decades ahead, the dependency ratio—the ratio of the elderly to those of working age—stays virtually the same.

If you divide the number of persons age 65 and older by the number of persons age 20–64, the present ratio is 21 percent, and 20 years out, 22. I mean, it will rise, but for the next 20 years, it ticks one. It doesn't change.

I want to get you all on record and then you can talk to each other.

Mr. Soss, good morning again, sir, and would you proceed?

STATEMENT OF NEAL SOSS, CHIEF ECONOMIST AND MANAGING DIRECTOR, FIRST BOSTON CORP., NEW YORK, NY, ACCOMPANIED BY ZWEN GOY, ASSISTANT VICE PRESIDENT (ECONOMIST DEPARTMENT), FIRST BOSTON CORP., NEW YORK, NY

Mr. Soss. Yes, Senator.

Senator MOYNIHAN. I have your testimony here. I will place it in the record and you go ahead. Read it if you like.

Mr. Soss. Yes. Thank you. We appreciate the opportunity to put the entire statement into the record and for the moment, my colleague, Zwen Goy, would like to present the summary.

Senator MOYNIHAN. I think this is a statement for both you and Ms. Goy?

Mr. Soss. That is correct, sir.

Ms. GOY. Mr. Chairman, Neal Soss and I appreciate the opportunity——

Senator MOYNIHAN. Do you want to bring that up a little closer? Yes. Bring that up a little closer, and talk into it.

Ms. GOY. Mr. Chairman, Neal Soss and I appreciate the opportunity to testify before the Subcommittee on the implications for the securities markets of the projected Social Security trust fund surpluses.

Senator MOYNIHAN. Ms. Goy, I can hear you. No one in the back will be able to hear you unless you just pump that microphone. It is not a characteristic Wall Street posture, but there you are.

Ms. GOY. Okay. The Social Security program is scheduled to swing towards sizable annual surpluses in the years ahead. This represents an effort to prepare for the foreseeable demographic consequences of the baby boom generation's passage through the workforce and into subsequent retirement. Since the Social Security program represents a portion of our fiscal policy, the projected surpluses may have an effect on economic performance and security prices.

The possible effects on the Federal budget deficit, however, are not enough to settle the question of where interest rates will go in the years ahead. For interest rates are not set by the budget deficit in isolation. The Federal budget has swung towards a larger deficit as a share of GNP in 17 years since the Korean war ended and interest rates were unpegged. In 7 of those years, interest rates fell, and in 10 years, they rose. The budget swung toward a smaller deficit in the other 17 of the last 34 years, with interest rates rising twelve times and falling five. What made the difference for

interest rates was how well the economy was doing and what the Fed was trying to accomplish with monetary policy.

Fiscal policy affects financial conditions indirectly, through the influence of the budget on economic activity. Last year provided a graphic illustration. From 1986 to 1987, the Federal budget deficit narrowed from $220 billion to $150 billion. That is $70 billion, one-third of the deficit, 1.6 percent of GNP. The Social Security trust fund contributed $3 billion of the overall deficit shrinkage. But a resurgent economy and tighter Fed policy contributed to a 300 basis point run-up in interest rates, just the same.

GNP has a more reliable though still imperfect track record in determining interest rates. When GNP growth accelerates, interest rates tend to rise; when growth subsides, so do interest rates.

Slower expansion in the supply of Treasury securities, however, should this occur, would tend to widen spreads between the yields on Treasury securities and the yields on mortgages, corporate bonds and other types of debt securities. It is, however, questionable if there would be any meaningful reduction in the absolute volume of Treasury securities, although the amount of marketable debt outstanding could eventually shrink relative to GNP and total credit. Even if the Social Security surpluses accumulate as projected, the absolute volume of Treasury securities will continue to grow unless the deficit in the rest of the Federal budget shrinks as a percentage of GNP.

The flow of goods and services baby boomers will consume in retirement beginning several decades hence will have to come out of the economy's production then. The only way to save for that flow now is to invest in physical and human capital that will increase the economy's subsequent productive capacity. A Social Security trust fund surplus will be constructive in this regard only if other policies, fiscal, monetary and regulatory, encourage investment versus consumption in the 1990s and beyond.

Thank you.

[The prepared statement of Neal M. Soss and Zwen A. Goy appears in the appendix.]

Senator MOYNIHAN. And sir, do you want to pick up?

Mr. Soss. I have nothing to add to the summary. We will be glad to answer any questions that you have.

Senator MOYNIHAN. Oh, fine. I see that phrase that the projected surpluses are awesome to our sensibilities. They really are. Let's see. I think we get to about $4.5 trillion in the year 2010, which is not a long time from the point of view of investment now. Mr. Gordon, you would know offhand. That would be about the present value of the New York Stock Exchange?

Mr. GORDON. Yes. With the numbers you are using, it would mean more to Japan to find in terms of trillions of yen in terms of money we think about. Money we think about is in terms of billions. Yes, it would an extraordinary amount. The forecast is that you are going to have a $12 trillion fund by the year 2030, which is certainly one that is awesome. It is very difficult, almost, to assess this and put it into place.

What you really are talking about is a diversion that did not create a diversion of assets. It would not be utilized in some way for purposes other than what it was intended. There could not be a

subterfuge that in some way, the government is not spending some place else and you will hide it inside the budget. We would urge that it be pulled outside, but these are truly mind-boggling numbers; there is no question about it.

This thing enters on the financial picture, and it is a factor of enormous size. As big as the U. S. economy is, it is a factor of enormous size.

Senator MOYNIHAN. How are we going to see that we behave? We clearly have the possibility of using this surplus, this reserve, to disguise operating deficits, and if we do, well, we will just have used it up, that is all, and it will have done nothing more than buy more of whatever it is government consumes.

I guess I want to ask the panel its view on this, and then I will ask each of the witnesses: Do you not agree, and you will obviously see our position, that the Social Security trust funds should be taken off budget and set over here as a separate account such that whatever the Federal government takes in in revenue and spends in other programs is shown separately and either is in balance or not, but it is not disguised. Can I just go one, two, three?

Mr. GORDON. I would regard that as essential. I would think that is a very critical fund, that the fund not be buried away in the unified budget but be set aside clearly, where it can be seen and where it can be identified.

I think that is part of the skepticism that we have found welling up from people that we have spoken to, and that is that somehow, they are going to hide this inside the budget or inside the overall expenditures and we are not going to know, and it is going to be quietly drained away, and it is going to look great. No, I think it has to come out in the open where it is seen. It has to be broken away from the major expenditures.

Senator MOYNIHAN. I was in the White House the first year that the unified budget was put in place, and I don't think that there is any doubt that we knew what would happen. The Johnson Administration wanted to disguise some of the costs of the Vietnam War. They weren't massive in terms of the present deficit, but that was the concern.

Mr. GORDON. But that is why, that is where; that skepticism has a genesis in the history. It is there. You can point to any number of different places where that has been involved and people have been disappointed. This is so large that it is probably going to be difficult to obscure, no matter what the number, but it certainly should be broken apart and put out into the open where it can be seen. It is of great significance. I think it is of great significance in terms of assuring people that they will have defined funds available to them in the years to come as they age.

Even the Yuppies, you know, who are finding out that there is life after 40 and realize that they have to kind of prepare for what is going to happen realize that this Social Security fund has, as now structured and the whole concept has changed, as I remember, has become an integral deal part of the retirement plans. I think there is a very significant responsibility embodied in that attitude, alone .

Senator MOYNIHAN. Ms. Goy.

Ms. GOY. I agree. I think the source of the funds is also different. The Social Security funds come from a tax on the payroll. It is a regressive tax, while the rest of the government is financed through a progressive income tax. So that would be an added factor why they should be separate.

Senator MOYNIHAN. Right. Right. Mr. Soss?

Mr. Soss. I don't have any great expertise in budgetary accounting, per se. I want to suggest as an economist that the question whether it is on budget or off budget is a budgetary issue, not an economic issue.

Senator MOYNIHAN. Oh, yes.

Mr. Soss. Definitive of all this.

Senator MOYNIHAN. I mean, all this money makes its way to the Federal Treasury.

Mr. Soss. Precisely, and back into the economy in one form or another.

Senator MOYNIHAN. And back out into the economy in some mode or another.

Mr. Soss. If I may, Senator.

Senator MOYNIHAN. Go right ahead.

Mr. Soss. Let me pass from the budgetary issue to these issues of size, because we do think of these numbers as very, very large, in part, because we have in mind the scale of the economy we are working with today. The GNP, at the moment, is on the order of $4.5 trillion, and so any number bigger than $4.5 trillion sounds like a very big number all by itself. But by the turn of the century, the GNP of the United States will be over $10 trillion, and by the middle of the next century, it should be over $100 trillion, with just normal growth in real activity and in prices. In that sense, these are, indeed, very large surpluses, but they are not as awesome in their time as today, much in the same way that we think back on some of the things you were commenting on, the original unification of this program into the budget.

In the Johnson Administration, if someone had suggested a $4.5 trillion number, it would have sounded very large, but it is only the GNP of the U. S. in 1988.

Senator MOYNIHAN. As John Westergaard, who Mr. Gordon interviewed so many years ago, pointed out, we still have a good chunk of this century to get through, and the makings of a very powerful economic response are here.

I would like to just make a point to Mr. Gordon's observation about confidence. It is peripheral to your concerns in markets, but I have a bill which provides simply that people get annual earnings and benefti statements from Social Security.

Right now, I think it may be something we want to hear more about from Canada. The lack of confidence may be related to the fact that you just never hear from Social Security until you retire or die.

Mr. GORDON. Or come close.

Senator MOYNIHAN. Or become disabled, yes. So you just don't know what is there. It seems to me in an annual statement, we can print these things out and mail them, and just tell you what your account is, like the Dreyfus Corporation. You tell people what is in their accounts, I suppose, regularly.

Mr. GORDON. Well, it is an excellent idea, one of the reasons being that just comes to mind, if I want to know what my Social Security account is, I have got a little post card or something where I can call people up and you can get that judgment that, "Gee, it is my money. Why don't I know where it is? They have taken it out of my taxes, and why isn't it there?"

That is an excellent idea. I wouldn't want to count; unfortunately, people very often don't reads these things, don't understand them. You find that you give a prospectus on the fund, just to use that as an example, to someone, that they really don't read it, certainly, as diligently as they should. In many cases, they don't read it at all and they are not aware of it.

But I would certainly say that an effort in that direction to indicate that the Social Security fund is certainly concerned and compassionate enough about these people to let them know what is there would be a major step forward.

Senator MOYNIHAN. Just to be clear that they do know your name.

Mr. GORDON. Well, you are telling them, in effect, "I know you are alive and out there, and at some point you may draw on this thing, and I think it is important for you to know." It is important for people to know that their fund is important. I think there is a surprising body of people that are not aware of Social Security in terms of what it means or how much is involved or what they are likely to get or anything of that sort.

Senator MOYNIHAN. Oh, let me tell you. The number of persons who know, are aware of survivors insurance; you know, you ought to know that if you are a husband with children or a wife with children, but people don't know it, and ny concern has always been, you know, if you think the government is lying to you about something like that, what else do you think the government is?

Mr. GORDON. I won't comment on that one.

Senator MOYNIHAN. I know. I have one last question for the panel that Andrew Samet gives me, and it is beyond my capacities to summarize, so I am going to read it, and tell me what you think. The question is: What do you think the role of substitution is between personal and private savings and Social Security pension fund savings? If the rate of substitution is high, the pension Social Security benefit expectations will probably erode personal savings. Thus, if we do not save Social Security surpluses, we will knock savings on its head, or do you agree?

I guess, as I would put the question, if the rate of substitution is low, then perhaps maybe the impact of not saving the surplus is not so great. Does anybody know anything about that subject? Has it been measured? I see Mr. Soss.

Mr. Soss. No. I think you mentioned earlier, Senator, that there is a difference between the rights to opinions and the rights to facts. I am not sure anyone knows anything about this subject but have some opinions on that.

Senator MOYNIHAN. Welcome. Welcome.

Mr. Soss. The first is, that, of course, if you are worried about that, you might take some comfort from the fact that so many citizens are so worried about Social Security's being there for them,

that is what encouraged them to go to the private sector for their savings.

Senator MOYNIHAN. Perhaps we don't want to build to much confidence.

Mr. Soss. Not too much, but more to the point, it seems to me that the regressive aspect of the tax that is being used to build this surplus over the years may have a negative effect on saving in the United States. The taxes come disproportionately from levels of income at which saving is difficult enough in the first instance. I am not sure that raising revenues from there doesn't diminish, in fact, the sum total of private savings in the personal sector.

Senator MOYNIHAN. Well, I don't have any facts, either, but I have an opinion, which is that savings rates are deeply culture-bound and don't respond to exhortation. Certainly, I mean, our problem as an economy, to the degree we have problems, is basically one of savings, right? The Japanese have four times our savings rate.

Deficits, per se, don't matter. They have deficits, too. It just depends on how much you save. Of 24 OECD countries, we rank 20 in savings, followed by Iceland, Greece and Guatemala or something like that.

I mean, you could answer questions like that. You would know an awful lot more than I do.

Mr. GORDON. Shopping is like a narcotics, you know. A lot of fun, it is a great way to kill time, and you go out. I would certainly agree with Neal. I don't think there would be a significant substitution in that regard.

I would point out that there would be a defensive measure happening here. Again, the skepticism that is present, would obviously inhibit people, but if you noticed in the recent, in the market break and things of that sort, people view their assets and their income flows as significant, and they built up their own resources and to protect themselves, and the sooner they determine that their resources haven't been impaired to the degree that their income was impaired, they felt quite confident, they rode out much of that market decline.

I would suspect that, as you say, it is deeply imbedded culturally that people say that I think that while our rate is low, unquestionably low, nonetheless, I don't think that this would alter it. I think the creation of this fund is an additional source of income in those years when we need them.

Senator MOYNIHAN. I could make you the argument that the notion that there is a secure future might give people the disposition to make it even more secure.

Mr. GORDON. Yes.

Senator MOYNIHAN. I want to thank this panel for very careful testimony. Mr. Gordon, you are so well regarded and your colleagues won't mind my referring to your venerable reputation in our city and nation, and for you to say that these sums are mind-boggling to us.

I shall take the word down to Senator Dole and tell him that you said so, and it wasn't the worst 12 days' work that we ever did.

We have been, in all truth, a little surprised, but I would also ask you to think that we intended this effect. We didn't necessarily expect it .

Mr. GORDON. Okay.

Senator MOYNIHAN. And thank you very, very much.

Mr. GORDON. Thank you.

Senator MOYNIHAN. We will see that when these proceedings are recorded in this record, that you will all have copies for yourself.

Mr. GORDON. Thank you very much.

Senator MOYNIHAN. We will be asking you, in fact, to correct your statements as part of the inevitable in the transition from the spoken word to the printed.

Mr. GORDON. Thank you.

Senator MOYNIHAN. Now we have the pleasure of hearing from Mr. Donald Coxe, who is the Managing Director of Wertheim, Schroder and who is a Canadian national, or was, and worked with the, am I correct, Mr. Coxe, with the Royal Commission in 1966?

STATEMENT OF DONALD COXE, MANAGING DIRECTOR AND CHIEF PORTFOLIO STRATEGIST, WERTHEIM, SCHRODER AND COMPANY, INC., NEW YORK, NY

Mr. COXE. I was on the Royal Commission on Pension, Senator, which reviewed the Canada Pension Plan Act after being in operation for awhile. I was on the Royal Commission in 1981.

Senator MOYNIHAN. I got you. In 1966, you had not been placed on the Royal Pension Commission.

Mr. COXE. But I was on the Canadian Pension Advisory Committee, which was the oversight committee from 1970 until 1976. All of the legislative amendments that came to the plan during that period came through our committee.

Senator MOYNIHAN. Through your committee.

Mr. COXE. So I had 10 years' experience in public policy directing that to the Commission.

Senator MOYNIHAN. Go right ahead, sir, with your testimony, and we look forward to it with much anticipation.

Mr. COXE. Thank you, Senator. Let me express my appreciate for the invitation to come and speak to the committee. As a Canadian who has had as much involvement with the public pension legislation in Canada, I am very pleased that we have a chance to comment on our experience, because some of it is very relevant to the kinds of issues that you have raised with the panel members earlier and in your own writings on this subject, and my remarks this morning will be focused on those areas where I think the Canadian experience is most relevant to what you are looking at today.

Senator MOYNIHAN. We will place your written testimony in the record. You proceed exactly as you feel most comfortable, which includes reading it, if you like.

Mr. COXE. I will assume it is in the record, Senator.

The Canada pension plan began in 1966, and one of the first things you have to understand is that in Canada, because of our constitutional division of powers between the Federal government and the provinces, we could not set up a Canada-wide pension plan

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such as you have been able to do in social security in the United States.

The Government of Quebec declined to go along with the Canada pension plan, and so what we have is a Canada pension plan which covers the rest of Canada and a Quebec pension plan which covers the Province of Quebec.

My remarks will be mostly on the Canada pension plan, because it has been operated somewhat differently, although the benefit levels paying into the two plans are identical for retirees. When Canadians refer to the plans, they tend to refer to the CPP, Canada Pension Plan, QPP, Quebec Pension Plan, as if it were one overall plan. It definitely is not.

Senator MOYNIHAN. That shows how much I know. I thought Canada Pension Plan was a brilliant Canadian device but each of those words is in both English and French. Wrong again. Okay.

Mr. COXE. It is Regime de Rentes in Quebec. Well, Senator, what happened with the Canada Pension Alan when it set up was partly because the Province of Quebec wished to create a development fund. They put in prefunding, partial prefunding for the plan. That was not the original concept, and the Province of Quebec went its own way and, in fact, has always invested part of the proceeds in the Quebec market.

By the way, Quebec's wisdom in this respect of having their own development fund came to light when they elected a separatist government in 1970s. Had this fund not been able to help them, it is doubtful whether Quebec could have done some of its public financing. I will put Quebec aside and concentrate on the Canada Pension Plan.

So we had this fund in the Canada plan, which is forced savings from all the workers in Canada. Although it was considered to be a small-scale operation, it grew very rapidly, and what has happened, then, is that the Provinces and Quebec who have and again, there is a distinction from the United States, the Provinces in Canada have the prime legislative responsibility for social programs, including particularly expanded education, including higher education in Canada.

For example, university students in Canada pay maybe 15 percent of the cost in tuition. The rest is paid by the state. Medical care in Canada, is totally paid by the state. These are programs that run at the provincial level. The result was, Senator, that during the 1970s, governments found demand for their deserved success were growing faster than their revenues, so the Federal and provincial governments were routinely running growing deficits, but the Canada Pension Plan was there to fund the provinces.

Now, there is an egalitarianism about that. The Province of Newfoundland is able from the fund the same as the Province of Ontario. This has been one of the ways the fund has equalized the financial operation. The CPP in Canada is very important given the economic disparities in Canada.

What the Canada Pension Plan did was to, in effect, take the Provinces out of the long-term bond market by supplying them with enough financing so that they stayed away from the long-term bond market. That was crucial to Canadian economic development,

Senator, because we have no tax subsidy in Canada for provincial debt such as you have in the state municipal debt.

Senator MOYNIHAN. The tax exempt bond?

Mr. COXE. Yes, that is right. Therefore, it would have been quite impossible during some of the turbulent periods of the 1970s and early 1980s for some of the provinces to raise money had it not been for the fact that they had monthly cash flow at the Federal government's interest rate coming from the fund.

So that the first point I would make is that this fund, although it hadn't been planned that way, became the backbone of provincial finance in Canada, and therefore, indirectly became the backbone of the entire long-term debt market in Canada. It is one of those cases where the founders built better than they knew.

I will just pause to comment on your suggestion earlier, in case I forget it, about advising members of the plan. When I was on the advisory committee, we kept asking the government to send out reports to people so that they would know that the plan existed. The government resisted for awhile, and finally, it started doing it. We discovered, to our horror, when notifications were sent out that the error records or error rate was over 15 percent.

Now, this is crucial, because you could only collect benefits under the plan if you can prove how much you contributed to the scheme over the years.

Senator MOYNIHAN. Yes. Yes.

Mr. COXE. Since very few people keep their income tax records more than a few years, if you did not, in fact, get the record out, and it is a self auditing system, then when you came to age 65, you might not be able to collect anything like your full level of benefits.

So that when the government started doing this, then, it had two effects. First of all, we found out all the errors in the system and cleaned up the computers. But secondly, it gave people a sense that this program was not, as the insurance industry in Canada had suggested, a gigantic fraud that was going to go bankrupt, but rather, it was a sound social insurance program run on an actuarily sound basis.

Part of the story of the seventies, Senator, was that the program gradually gained credibility with the public because of those two features: One, the existence of the fund, which kept growing and growing, it became so important in financing the country; secondly, the reporting system to the public so people had a chance to see that they had what they regard as their retirement account there. So I think both those features are perhaps of some use.

Senator MOYNIHAN. And, if I can, that is very much worth hearing. That annual statement is a management quality control. If people start writing in and say, "Hey, I don't live here any more," or, "That is not the way I spell my name," or "Where is my statement?" Then the system itself will be getting some feedback as to how well it is doing.

Mr. COXE. That is correct, sir.

Senator MOYNIHAN. I think you would find that our Social Security Administration, it is a half century old, and it can't be error-free, but it is at a very high level of performance in terms of the accuracy of what people receive and the regularity with which the checks are sent out. But still, it is a management information

device to make sure that you are doing it right. That is a good point. Thank you.

Mr. COXE. The chairman of our Royal Committee on Pensions, who is a distinguished Canadian judge, when I was pointing out this error rate, found it hard to believe, and so she applied. At this point, there was no automatic system of reporting. She applied to get her own earnings record and discovered that although she had been contributing the full rate as of a lawyer and then as a judge, that she was recorded in the file at the poverty line, which would have meant that the pension she would have ultimately received would have been that for the lower end of the pension scale.

Senator MOYNIHAN. Mr. Coxe, I must interrupt. You are being filmed on television. Make clear this happened in Canada.

Mr. COXE. Yes. Yes, Senator.

The point is, when this fund evolved this way, Senator, what it meant was that when Canada entered an economic crisis in the early 1980s, the fund turned out to have enormous impact on Canadian financial markets and, indeed, I am not going too far to say that I find it hard to believe that the Canadian dollar could have held up at all in the early 1980s had it not been for the existence of this fund.

The reason for that, Senator, is that Canada has been, at all times, very much dependent on importing foreign capital, and part of that has to do with the fact that we are strung out along the border. Eighty percent of Canadians live within a few miles of the American border. It is expensive operating an economy that way.

Second, Canadians have always had a much greater appetite for and acceptance of government programs than Americans. Therefore, the demands on government have been greater.

Third, it costs more to create a job in Canada because of the resource orientation of the economy. To give somebody a job in the mining industry costs about $500,000 of capital investment. It doesn't cost that much to give them a job in the computer industry here. So therefore, the amount of capital investment required to create a job in Canada is higher.

Therefore, we have imported, always, more capital than most other OECD countries. In the early 1980s, Canada got hit on all sides. Commodity prices stumbled, interest rates soared, and meanwhile, our governments had been running huge deficits far beyond what the United States has ever run. With all the talk about Congress' spending, the Canadian government deficits in relation to GNP have been, every year for the last 15 years, far higher than the United States.

So a combination of the fact that the governments were in a bad financial position going into the 1980s, anyway and then a serious recession, high interest rates, and the Canadian dollar got in very serious trouble, and had it not been for the forced savings of this fund and the steady growth of this fund through the period, I think the Canadian dollar would not have held up in anything like 68 cents United States. Many forecasters were predicting it would have collapsed to 50 cents.

It turned out that that was our ace in the hole as a nation, because when the foreigners turned away from Canada and said, "We don't want to supply you with capital; we aren't interested in our

resources any more." Oil prices have gone down. Then Canada had to find domestic savings.

So the forced savings that we had domestically turned out to be crucial at that time. Now, a nation that finances its own economy and government is able to set, to a major extent, the prices of its own bonds and stocks. A nation dependent on capital imparts to finance its economy and government must, to a major extent, let foreigners set the prices of its bonds and stocks.

Since we had very few provinces in Canada with the kind of credit ratings that could have survived a crisis like that, coming through that was a major event. But I think for the American experience, then, now that the United States is as dependent on foreign capital as Canada was in 1980, given the current account deficit and the large external debt, that the question of always relying on the availability of foreign capital, particularly in the long bond market, becomes of relevance for the American experience.

Senator MOYNIHAN. Mr. Coxe, is that $500 billion, is that now a settled number that we have of the external debt, or that is your number?

Mr. COXE. That is a good question, because there are arguments about it. That is the kind of figure that Europeans—I have just come back from Switzerland—continually use, and therefore, in effect, you could say the marketplace is assumed.

Senator MOYNIHAN. It might as well be so, because people have taken that as a given. I will just interrupt again. We don't know how much of our government debt has gone abroad; there is just no way to know.

Mr. COXE. That is right. Once you remove withholding taxes and make the bonds bearer bonds, they cease to have a nationality.

Senator MOYNIHAN. Yes.

Mr. COXE. The Canada Pension Plan has always bought 20-year bonds from the provinces. This is, I think, of crucial importance. What it has meant is several things. First of all, it supports the long-term end of the bond market, which is the most vulnerable whenever a currency crisis occurs or whenever there is turmoil the financing system. It means the provinces could always get the cash flow.

Second, it means because that area of the market had more internal stability than it would have had otherwise, it meant that other long-term financing in Canada, such as corporations and mortgages has been stronger than it would have been otherwise.

Third, it has meant that the actuarial work of the Canada Pension Plan has been splendid. The forecasts have worked out with almost mystical precision, and one of the reasons is that once you have a 20-year bond in your portfolio, you know what its interest income is going to be, whereas if you have short-term instruments, the interest rates fluctuate wildly.

We have a statistic in here showing the tremendous importance of the interest income of the plan. Last year, 47 percent of the cost of retirement pensions was covered by the interest income.

That is fascinating, because a typical private pension plan, two-thirds of the cost of a pension is paid by the investment income. So to have a social insurance program where the interest income

covers such a large part of the cost of benefits is, I think, an extraordinary accomplishment.

But it could not have been done, had the fund invested in short-term instruments. First of all, you get higher income at the long end of the scale.

Second, we would not have had as much economic stability if that end of the market had not been stabilized. So that I feel that if, in looking at the elements of the Canadian experience that are helpful for the American experience, if I had to choose one above everything else, it would be that.

Senator MOYNIHAN. I am sorry. We are just asking about our portfolio. There is a special Treasury bond which the trust fund purchases which cannot go below, sell below face value, and I guess we have a mix that I don't know much about. There is a five-year bond; we buy some of those, and some 15, some 20. But you would urge us to get over into the 15 and 20?

Mr. COXE. Senator, I would strongly urge that the Social Security trust fund acquire all new 30-year Treasury bonds, because then the duration of its assets would more closely approach the duration of its liabilities. That long end of the market which is the one where the foreigners have tended to have the greatest impact in terms of the last fall's crisis, would therefore be self evident in the United States.

Senator MOYNIHAN. Your advice would be for us to concentrate to buy, you say, all the new thirties?

Mr. COXE. Just take the Treasury right out of the public bond market. It also means the Japanese would no longer be able to have the kind of tremendous influence on new Treasury offerings, and furthermore, it would also mean total prediction on interest income of the fund. You don't need liquidity in the fund that is not going to peak until the year 2030.

Why not get the maximum interest income and use that to reduce the cost of benefits and thereby stabilize what is the most volatile area of the bond market? That could be done with American forced savings.

It would have, I suggest, the same impact on the American dollar in the long term, and particularly in a crisis, that it had on the Canadian dollar.

Senator MOYNIHAN. That it had on the Canadians. You are going to have to take me through. If I understood 30-year Treasury bonds, Mr. Coxe, I would own one. And so I am going to have to ask you to take me through this. Obviously, this is the bond curve, and when interest rates are uncertain and exchange rates uncertain, you get a fairly healthy discounting in the outer years; is that how the Japanese—You tell me. Don't let my words confuse you.

Mr. COXE. Senator, at the moment, there is no discounting at all. The yield curve as we call it, in the United States Treasury bond market now, between the 10-year and the 30-year area, if you look at that, that looks like a topographical map of Kansas.

Senator MOYNIHAN. Oh, really?

Mr. COXE. If you look at the situation last September and October, the yield curve was steeply sloping upwards, because foreigners were bailing out of Treasury bonds. For somebody investing

into a country from outside, the highest risk asset you can acquire is the longest term bond.

Senator MOYNIHAN. So you will require the most return on that?

Mr. COXE. Yes. Conversely, if you believe that the currency is going to be strong, the asset you most want to own is the longest one. One of the reasons the long end of the U. S. bond market is performing so well right now is the dollar has turned stronger. If one were to believe that that will last forever until the year 2030, then the Canadian experience would not be as relevant.

But if one thought there is a chance we could go through the same kind of horrors we went through in September and October, then the idea that the long end of the U. S. bond market was automatically stabilized from internal cash flow would be very reassuring, particularly to the mortgage market, because so many things, Senator, within this country are priced either nominally or actually off the yield on long-term Treasury bonds.

Senator MOYNIHAN. Your advice to our money managers is for the trust fund to start buying all 30-year Treasuries?

Mr. COXE. Yes, Senator. I don't believe that any more should go to the public. There is a large cost to the Treasury in doing so, because bond underwriting—that is the highest charge areas for new underwriting—is the long bonds.

Senator MOYNIHAN. We have got you.

Mr. COXE. Canadian taxpayers have saved millions upon millions of dollars by not having new long-term bonds issued by the provinces. Quite frankly, that is the only group in Canada that has lost from the investment policies of the Canada Pension Plan is bond underwriters.

Senator MOYNIHAN. I am going to report this to the Secretary of the Treasury. He, I guess, makes that decision, doesn't he?

Mr. LOPEZ. He is the managing trustee.

Senator MOYNIHAN. He is the managing trustee. That is a strange thought, that we can even talk about such things, but we can now, can we not?

Mr. COXE. Senator, I was talking with a group of Swiss bankers last month and outlining my expectation the Treasury would, of its own volition, reach this decision very soon because of the cash flow that you have demonstrated the fund had. I can tell you that almost nothing, and I have seen the bankers in Europe for years, has as big an impact on them in the sense of the United States having its affairs under control as the notion that the United States long-term bonds would be internally self financed. That to them was a huge change of thinking and they said, "Well, in that case, we don't have to worry as much about the U.S. debt market because the high-risk area is covered internally."

Senator MOYNIHAN. Right. And to the degree that that worry level goes down, the cost level, costs, go down.

Mr. COXE. Absolutely correct, Senator, and the value of the dollar would probably go up, because it would mean they would be more willing to acquire other U.S. assets when they aren't worried that the long term bond market won't go into the kind of disarray that it did last fall.

Senator MOYNIHAN. Very impressive.

Please.

Mr. COXE. Do you have any other questions, Senator?

Senator MOYNIHAN. Well, I do, yes. Mr. Samet says he believes the Congress has a limit on the amount of 30s, he says here, that can be issued by Treasury. That may have depressed the yield curve. Well, we will find that out, won't we?

Mr. COXE. I can comment on that, Senator. There is an antiquated law on the books which requires that any bonds issued by the Treasury having a yield of more than four and one-quarter percent that Congress must renew the authority from time-to-time.

I am a sort of an Anglophile. I enjoy this law because it is somewhat like some of those English rules of peppercorns and things, because, of course, that rule has been on the books during a period of time, when there hasn't been four and one-half percent bonds. It is an act of fantasy.

Senator MOYNIHAN. I know that, because we have been on the floor and re-enacting it. I said, "What are we doing? Why are we doing this?"

Mr. COXE. As it happens for this year, the authority has expired. Congress must issue new authority. What I am suggesting is: Why bother ever doing it? Have the Treasury simply issue the bonds to the fund, which will benefit from them, and future Social Security recipients will benefit from the fact that the costs will be going down, the size of the fund will be going up, the actuarial forecasts will be that much easier, and it will mean one less thing for the Congress to have to authorize each year.

Senator MOYNIHAN. One less bill. Listen, I want to thank you very much, sir. That was very powerful testimony. Next year, if I can get back to the Senate, we are going to ask some Canadians down and maybe go up and talk to them. We are, after all, neighbors, and I think it is time that we learned more about international experiences with social insurance.

There are different patterns around. But the idea, your idea that if we--now you report from Switzerland at that time if the Swiss were to observe us, these funds being the sole market for 30-year Treasuries, then the impression that would make, that is a powerful idea. We can do it, and it ought to be something thought out, and these issues of confidence are hugely consequential, because if you if you ever pierce the veil of money, you are in a lot of trouble.

Mr. Coxe, we thank you very much. We are most appreciative.

[The prepared statement of Mr. Donald Coxe for the record appears in the appendix.]

Now to our final witness. Ms. Judy Brown, member of the board of the American Association of retired persons.

STATEMENT OF JUDY BROWN, MEMBER OF THE BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, DC, ACCOMPANIED BY JUDY SCHUB, SENIOR COORDINATOR OF FEDERAL AFFAIRS, ECONOMIC TEAM, AARP

Senator MOYNIHAN. Ms. Brown, would you come forward, and if you do have an associate with you, she is most welcome.

Ms. BROWN. Thank you very much, Senator.

Senator MOYNIHAN. We very much look forward to your testimony. If you would introduce your associate?

Ms. BROWN. I will be glad to. This is Judy Schub, who is the Senior Coordinator of Federal Affairs, economic team for the AARP, and I have come from Minneapolis, Minnesota and Judy has come from Washington, and we are very glad to be here.

Senator MOYNIHAN. The secret is we know Ms. Schub, but we have to introduce her for purposes of the hearing. Would you proceed? You have written testimony. We will put that in the record, and then you proceed to read it, if you like, or summarize it as you like. Do exactly as you wish.

Ms. BROWN. Thank you, Senator. I would like for a moment, if I may, before I read my summary, to continue Mr. Coxe's conversation a little bit. In exploring the issues of taking the reserves of the trust fund out and looking down the road as to the size they are going to be and the fact that the trust fund could purchase all the Treasuries, one of the things that could be explored is the issue of the confidence level, and Americans presently, particularly older Americans presently put some of their monies into Treasuries.

It is a very important part of their savings scenario, and if, in fact, the trust fund purchased all the Treasuries, we could explore the fact that perhaps that might enhance things for American banks in that people who are looking for guaranteed returns, things they could count on, might start to look more towards the banks as a saving vehicle which, then, does things for mortgages, et cetera, et cetera, et cetera.

But it is a possibility that that is one of the strong benefits that could occur from the trust fund purchasing all or most of the Treasuries, and there are many other benefits, but I would like to read for a few moments, if I may.

Senator MOYNIHAN. You go right ahead.

Ms. BROWN. We, of course, thank you for the opportunity to be here. We commend you for holding the hearing to discuss the reserves that we now have in the Social Security trust funds. We believe there are three major issues which need to be dealt with. The first is that we believe that the reserves need to continue to accumulate so that older people will understand that the funds will be there for them when they are ready to take them in retirement.

Second, that we would explore the gradual extrapolation of the reserves from the budget. We think there could be problems in trying to do it in one fell swoop.

Third and perhaps most important is to ensure that the reserves are put to use in a manner that, in the long run, enhances our national prosperity.

With respect to the first issue, we do encourage the extrapolation of the fiscally-prudent reserves and safeguarding against those reserves being jeopardized.

Second, we think that the trust fund build-up, while the government's operating budget is in substantial deficit, has been receiving considerable attention. The occurrence by itself would not be cause for concern. However, the Gramm-Rudman-Hollings deficit reduction goals are currently met only through the inclusion of the trust funds, and therefore, masking the size of the deficit.

The final issue that we think is important is ensuring that the reserves are used to enhance the national wealth. It is a most difficult issue and an interesting one. When the 1983 Social Security

Amendments were passed, the most potential issue accompanying the reserve's build-up were recognized. However, the primary concern in the early 1980s was to prevent the trust fund's insolvency and restore the public's confidence in the system.

Many believe the reserves could be a great boon to the economy. However, their impact depends on how they are used before they are needed to pay for such benefits.

If the reserves are used to finance current government consumption rather than government investments in future productivity, a long-term result would be even greater overall deficits and an inadequate retirement fund, and we think that cannot happen, obviously.

AARP believes that in order for the trust fund reserves to serve the purpose for which they were designed, to help pay for the baby boomers' retirement, they must be used in a manner conducive to economic growth. If so used, the total economic pie in the future will be larger.

Some worthwhile future uses in the public sector might include educational programs and educational loans; training programs; infrastructure development; nutritional programs for infants and pregnant women or Federal activities to enhance research and development. All increase future productivity and living standards.

Unfortunately, until all the trust fund IOUs come due in the next century, the reserves could also become a tempting pot of cash to finance programs that do not promote economic growth.

This would be a disastrous budget crunch when the reserves are needed to pay benefits and probably would result in what younger workers fear most, that the Social Security program will be substantially altered to reduce costs. This scenario would be a most regrettable and ironic outcome from so successful a piece of legislation as the 1983 amendments.

We should be dealing with the long-run opportunities presented by the Social Security reserves now, in a non-crisis atmosphere that allows all reasoned views to be heard. We think this is a most important issue, and we would welcome public debate.

As one of the principal architects of the 1983 Amendments, you, Senator, have repeatedly demonstrated your commitment to a strong Social Security system for both current beneficiaries and for the future. And as has been discussed many times here this morning, the confidence of the people in that system and in the way those monies are invested is very important.

I will answer any questions you may have.

Senator MOYNIHAN. Well, thank you, and we have a number to ask. First of all, thank you for your nice, your kind remarks and for your closing passage in which you say that we can now think about this in a non-crisis atmosphere.

A couple of things. I hear you say that investments include such activities as educational loans, job training programs, literacy promotion, infrastructure development, nutritional programs for infants, support for research and development. That is a suggestion that we might use the Social Security funds rather as the Canada

Pension Plan, which has been made available to the provinces for building highways .

I would resist that, partly because we have tax-exempt financing for state governments as Canada does not. Would you agree that this is something we ought to think about, maybe, a decade from now, when we really know what we have, when the public debt is going down, the 30-year Treasuries are in that trust fund; people are getting their annual statement? I would be a little leery.

Ms. BROWN. We look to those ideas, Senator, we think, down the pike, at least a decade.

Senator MOYNIHAN. Yes.

Ms. BROWN. When we think of the fact that there will come a time when we will buy all the debt.

Senator MOYNIHAN. Yes. Yes.

Ms. BROWN. And then.

Senator MOYNIHAN. Yes. That is right. That is right. There will come a time when you will have, yes. That hasn't come yet.

Ms. BROWN. No.

Senator MOYNIHAN. But you can see it right there. It is, as I see Ms. Schub is nodding. The people involved have been or are born. But for now, you would advocate a policy of long-term U.S. government bonds?

Ms. BROWN. Right. We would like to see that explored and look at the pros and cons, but we think that is most probably the best way to go.

Senator MOYNIHAN. Yes. Well, we do it five, ten, 15. We can do it thirties now with no problem. We are about at $100 billion. We should be clear about the numbers. A $100 billion reserve is only a 6-month reserve.

Ms. BROWN. Right.

Senator MOYNIHAN. But when we are at $200 billion, then I think we, with complete confidence, we can; the present mix is such that you could probably go to the 30-year route now and have plenty of nearer-term monies, and you go to it as a matter of policy but change your mind any time in the week.

I think we buy bonds once a week, don't we?

Mr. SAMET. Yes. That would include weeklies or monthlies.

Senator MOYNIHAN. Yes. We buy bonds once a week, and this week, buy 90-day Treasury bills, if you so disposed.

Ms. BROWN. And I think it could be noted, as you just stated, that we do not yet have a one-year reserve, but we know that businesses and trust funds need to look at having adequate reserves .

Senator MOYNIHAN. Right.

Ms. BROWN. So although the dollar amounts are large and are growing larger, we need to look at them in relationship.

Senator MOYNIHAN. So let's leave it alone until we have a solid year's reserve?

Two points, now. The idea of our sending out an annual statement of earnings, accumulated quarters, projected benefits. Would the AARP think that was a useful thing to do?

Ms. BROWN. I would think most probably so. I think also it will take people out of the crisis orientation, again. Most people deal with Social Security as they are approaching retirement or when

they are widowed or disabled, and it will give them an opportunity to understand what they have.

Senator MOYNIHAN. Yes. I was saying, you know, most people seem not to be aware that they have survivor's insurance, which is something they should know.

Something else, though. Aren't you impressed by the anxiety of older persons who are retired and are getting the benefits but still aren't sure the benefits are going to continue?

That is one of the things the AARP has done, is help to make people know, "You are not alone," but isn't that a real problem?

Ms. BROWN. Well, yes, I think it is a real thing, and I think as we all know, as we grow older, issues which might not have been monumental become more monumental. People who are retired do not have an opportunity to go out and earn their savings again.

So they are highly dependent on Social Security and the income from their savings, and they do need to have the comfort zone that it will be there.

Ms. SCHUB. May I add something?

Senator MOYNIHAN. Miss Schub, please.

Ms. SCHUB. That is one of the reasons that we are so concerned and you have expressed concern.

Senator MOYNIHAN. Would you hug that mike?

Ms. SCHUB. Use this microphone?

Senator MOYNIHAN. Yes.

Ms. SCHUB. So concerned about the issue of quality service to beneficiaries. When someone has a problem with Social Security, as your office knows, as we know, it is often because they cannot get information from their local Social Security office; they cannot get through on the telephone .

The classic casework problem is, "Social Security says I'm dead," and it happens and they cut off the checks, and the person has to get that rectified. It is very difficult for individuals, and they are very frightened, because they are so dependent, and what has happened in the past 10 years, unfortunately, so we have seen some diminution of service to the public.

Senator MOYNIHAN. Did we have to close those offices? I didn't know why we had to do that.

Ms. SCHUB. Many of us, throughout the history of Social Security offices, have been opened and closed based on need, based on population shifts. However, what some of us think has happened is that the budget pressure of cutting staff is now generating offices closings. There are literally not enough people in some of those offices to staff some of those offices.

Senator MOYNIHAN. I am going to get into that. We have had some great Social Security Commissioners like Bob Ball. You would know if they had a problem; he would come and tell you. I am not sure they will come and tell you any more.

Ms. SCHUB. I think that at many levels of management in Social Security, there is still a desire to be what they always were, which was the most responsive, most efficient government agency.

Senator MOYNIHAN. Nice.

Ms. SCHUB. And that is the history of the agency.

Senator MOYNIHAN. That is the history of the agency; you are right.

Ms. SCHUB. However, there is a feeling that within the past ten years, particularly, there has been a real erosion of that idea. One of the examples, and I am not sure it is Social Security's problem, but one of the benefits of sending out an annual earnings record is we know there are problems in recording earnings. That may not be SSA's fault. It may be IRS's fault, but it has taken a very long time to deal with this problem.

Senator MOYNIHAN. That is what Mr. Coxe testified to in Canada. The Canadian judge found that she has been earning the minimum wage and so forth. Ten years, you are right. And I want to make clear this is not a partisan matter. In the Carter Administration, a young man became Commissioner of the Social Security Administration, stayed six months, got it on his resume, and left.

I mean, I went on the floor, and I said, "Senators, he should be ashamed of himself." I mean, if you take that job, you take it for 5 years, minimum. This man acted like it was just something to tick off before they opened the law firm.

Should we have the Social Security trust funds off budget? Ms. Brown.

Ms. BROWN. Yes. We think they should be off budget. We think part of the issue is how to take them off the budget because of their size and their continued growth.

Senator MOYNIHAN. We can. It is in the law. We wrote it in the 1983 law. We just go back to where we were before 1969.

Ms. BROWN. I think we have some concern that taking something of that size off could have an impact on markets and that we think it should be looked at carefully to see whether we want to do it all at once.

Senator MOYNIHAN. All right. We didn't do it all at once. We said in 1983 we would do it in 1993, you know.

Ms. BROWN. Yes.

Senator MOYNIHAN. Next and last question. You don't have to answer, because it is not on the subject of the hearing, and so you may not want to make a policy statement, but how do you feel about establishing the Social Security Administration as an independent agency? If you would like to consult your board, just say you would like to consult your board.

Ms. BROWN. Judy says that our policy is to support that.

Senator MOYNIHAN. You do support that?

Ms. SCHUB. Yes.

Senator MOYNIHAN. Well, so do I. I mean, the notion, it is the most important Federal government domestic program we have, and you can't find it in the hierarchy of the Department of Health and Human Services. Have you ever looked at the government manual to try to find it? It is very difficult. And you have an acting commissioner for years. This needs to have its own budget set aside, and a Commissioner with a fixed term of office. It needs to be an independent body.

We did, in the 1983 legislation, establish two Public Trustees, but then the Treasury went ahead, you know, and took $28 billion worth of Social Security trust funds and used them for general revenue and didn't tell us, did not tell us. I mean, you know, the Secretary of Treasury didn't pocket them and flee to Monaco or anything. His choice was either that or to have the government default

on some obligations, but they didn't tell the Congress; they didn't tell my committee; and they didn't tell the Public Trustees, and the Public Trustees didn't resign.

I think a little more visibility up there, don't you?

Ms. BROWN. Yes. And we would like to thank you for your support and help in the Social Security effort. As we have these reserves, we hope we will carefully look down the pike to use that as a mechanism to perhaps stabilize some economic markets in this country as well as ensuring and enhancing the retirement of older people who are depending and the baby boomers who are helping to pay for that so it would be available to them when they are ready for it, too.

Senator MOYNIHAN. Ms. Brown, we thank you very much for coming here from Minnesota. It is a pleasant summer day. I hope you will not fail to check out the Metropolitan Museum of Art or any of the other pleasures of the city. It is very kind of you to come all the way from Minnesota, and Ms. Schub, we thank you for coming up from Washington.

If there are no other persons who urgently wish to be heard, we have completed the third and what will be the last of our oversight hearings this year on the conditions of the trust funds and their potential impact on our financial system and our budgetary system. This has been a very rewarding morning, and I thank all witnesses. We will ask you, if you may, to correct your transcripts into coherent sentences, as we all have to do, and we will see that you have printed copies.

Ms. BROWN. Thank you.

Senator MOYNIHAN. When copies are ready. With thanks to our very patient and very able and experienced transcriber and reporter, thanks to Mr. Samet, Mr. Lopez, to all, we now conclude this hearing.

[Whereupon, at 11:32 a.m., the Subcommittee recessed, subject to the call of the chair.]

Statement by
Senator Daniel Patrick Moynihan

We meet today for the subcommittee's third hearing on the long-range buildup of Social Security trust fund reserves. The focus of today's hearing is the impact on the financial markets of amassing $12 trillion in Social Security trust fund assets.

As Professor Alan Blinder said in yesterday's Washington Post, "the secret is out." The "secret", of course, is that in twelve days in January, 1983, a half dozen people in Washington put in place a revenue stream which is just beginning to flow and which, if we don't blow it, will put the federal budget back in the black, pay off privately held government debt, jump start the savings rate, and guarantee the Social Security trust funds for a half century and more.

This bright financial outlook is the result of the Social Security Amendments of 1983. It is more specifically the result of our decision to move from a pay-as you-go system to a partially funded one in order to ease the economic burden of financing the retirement of the baby boom. What is not generally known is that we established a means to increase

national savings and counteract the negative effects of the budget deficits of the 1980s.

We have now had four full calendar years of the new revenue base. The Social Security Board of Trustees has just reported, and on May 13 I held the first oversight hearing. Here are the numbers. The Social Security trust funds are increasing at the rate of $109 million per day and rising. The current reserve is approaching $100 billion. Between now and the year 2000 it will grow to $1.4 trillion. (As of 1987, the entire assets of private pension funds were about $1.5 trillion.) Trust fund reserves are projected to peak at around $12 trillion in 2030.

We face the opportunity to put aside the fiscal mess of the '80s. Our real economic problem is that we don't save enough. Of 24 OECD members, we rank 20, followed only by Iceland and a few such. Surely we should make our best effort to save the Social Security trust fund reserves.

Statement of
Stephen J. Entin
Deputy Assistant Secretary for Economic Policy
Department of the Treasury
before the
Subcommittee on Social Security and Family Policy
Committee on Finance
United States Senate
June 30, 1988

The Chairman and the Subcommittee are to be greatly commended for the close attention they are giving to the condition of the Social Security System and its economic influence. This is an important and complex subject which is too often ignored except when a crisis is imminent. This hearing into the long run outlook for the System is unusual in that it is being held at a time of healthy trust fund balances and rising annual surpluses, and is focusing on fundamental long term budget and growth questions which are not, and probably cannot be, addressed in the ordinary budget process.

In the last several years, the Trustees and the Social Security Administration have been working together to make more information available in the annual reports, and to present it in more useful form. Recent improvements to the Reports include provision of two intermediate scenarios, II-A and II-B; clearer presentation of the pattern of surpluses and deficits over 25 year subperiods, supplemented by the use of graphs; Appendix E, which shows the combined condition of OASI, DI and HI in terms of percents of taxable payroll; Appendix F, which shows the combined system in terms of percents of GNP; and Appendix G, which shows the long range estimates of Social Security Trust Fund operations in dollars. The material in Appendix G has been published since 1983 as a separate Actuarial Note, and was moved into the Trustees Report this year for the first time. It seems to have attracted some interest.

We shall continue to work to improve the Reports, in the hope of making them as useful as possible to the Congress, the financial community and the public. Any comments on the content and presentation of the Reports, or suggestions for additional material for inclusion, would be greatly appreciated.

I should also like to recommend to the Subcommittee a pair of just-released studies of the trust fund build-up and its possible economic and budgetary consequences. These very timely

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studies were proposed, commissioned and supervised by the two Public Trustees, Suzanne D. Jaffe and Mary Falvey Fuller, with the assistance of the Department of Health and Human Services. The studies were prepared by the Brookings Institution and by Lewin-ICF, Inc.[1/] I understand that the Subcommittee has received copies. I shall draw heavily on their discussion and conclusions in this presentation, and I have appended the final chapters of each study to my statement. Chapters 2 and 5 of the full Lewin-ICF study are particularly good at conceptualizing the relevant issues and spelling out the key assumptions about fiscal choices and the reactions of the public that must be made in analyzing the problem.

Components of Social Security

Social Security comprises the major set of programs affecting the elderly. There are four parts to Social Security, each with its own trust fund. The payroll tax is used to finance three of the four parts: Old-Age and Survivors Insurance (OASI), Disability Insurance (DI), and Hospital Insurance (HI, or Medicare Part A). The fourth part, Supplemental Medical Insurance (SMI, Medicare Part B), covers physician's fees and office visits, and is financed roughly three-quarters by general revenues and one-quarter by premiums; it needs only a small trust fund, as it has a direct claim on general revenues and the premiums are adjusted annually. OASI and DI are managed by the Social Security Administration (SSA), and are frequently referred to jointly as OASDI. HI and SMI are managed by the Health Care Finance Administration (HCFA). The three programs funded by the payroll tax are often referred to jointly as OASDHI. The 1983 Social Security Amendments mandated that OASI, DI and HI (but not SMI) be moved off-budget in 1993. The Gramm-Rudman-Hollings Act accelerated the shift of OASI and DI off-budget to 1986. Consequently, OASI and DI are currently reported off-budget, HI and SMI are currently reported on-budget, and HI will be moved off-budget in 1993.

Sudden awareness of the projected trust fund build-up has led in recent weeks to considerable discussion among interested parties. Some regard it as an unexpected solution to the budget deficit problem. Others fear that that is exactly what the trust fund surplus will be used for, financing other government spending rather than preparing for the retirement of the baby boom generation. Others fear that the trust funds will swallow up the whole national debt, removing the entire supply of Treasury bonds from the financial markets, complicating monetary

1/ "Final Report to Social Security Administration, U.S. Department of Health and Human Services on Contract No. 600-87-0072 to Brookings Institution", and "Study of the Potential Economic and Fiscal Effects of Investment of the Assets of the Social Security Old-Age and Survivors Insurance and Disability Insurance Trust Funds."

policy and portfolio decisions. Some fear an even more massive build-up which could require extensive trust fund investment in, and control of, large portions of the U.S. private sector.

Before proceeding to discuss these concerns, it would be helpful to put some of these figures in perspective.

The Magnitude of the Trust Fund Build-up

Table 1, derived from Table G-1 in Appendix G of the OASDI Trustees Report, shows income, outgo, near term trust fund surpluses and subsequent deficits in both current and real 1988 dollars. It shows that the OASDI trust funds will peak at just under $12 trillion shortly after 2030 under Alternative II-B assumptions. This current dollar figure is not adjusted for inflation. Alternative II-B assumes an average of 4 percent inflation over the next 75 years. As shown in Graph 1 and Table 1, the OASDI trust fund peaks in real terms shortly after 2020 at nearly $2.6 trillion in terms of real 1988 dollars. Alternative II-B projects that nominal GNP in 2030 will be nearly $55 trillion. Real GNP in 2020 will be about $8.9 trillion in real 1988 dollars.

Looking only at the off-budget OASDI trust funds neglects HI. HI is currently in surplus, but it will begin running deficits in 1993 under Alternative II-B assumptions. Its trust fund will be exhausted by 2005. The combined OASDHI trust fund build-up is much smaller than that of OASDI. Graph 2 compares in real terms the OASDI and combined OASDHI trust funds. In real 1988 dollars, the OASDI funds peak at $2.6 trillion in 2022, while the combined OASDHI trust fund peaks at $1.7 trillion in 2016, six years earlier.

Another perspective can be gained by looking at the source of the trust fund build-up. Table 1 shows that over half of the annual surpluses of the OASDI system after 2005 are due to interest from the general fund. Between 2015 and 2020, OASDI tax income, excluding interest, falls below outlays, and more than 100 percent of the build-up of the trust fund from $9 trillion to $12 trillion is due to the interest transfer from general revenues. (See also Table 3.) Table 2 shows the same pattern emerging earlier for the combined OASDHI system. The interest element of these surpluses, and this interest-related build-up, are an intra-government transfer. They do not contribute to a surplus for the unified budget, and are not part of the net impact of the OASDI system on the financing needs of the government or on the credit markets.

The unified budget impacts of OASDI and OASDHI are shown in Table 3 in current and real 1988 dollars, and in Table 4 in terms of percent of taxable payroll and GNP. It is the unified budget impact of OASDI, income excluding interest less outlays, which measures the impact of OASDI on the credit markets. As OASDI's outlays begin to exceed its tax revenues between 2015 and 2020,

OASDI will be increasing rather than reducing the Federal Government's borrowing from the credit markets. HI begins to run deficits on this basis in 1993. For the OASDHI system, the annual deficits excluding interest begin between 2010 and 2015.

Thus, the trust fund build-up overstates the net contribution of OASDI and OASDHI toward financing the unified budget deficit. Tables 3 and 4 show that the OASDI surpluses excluding interest never exceed $75 billion in real 1988 dollars and 1.1 percent of GNP. The more distant OASDI deficits are roughly 1.4 percent of GNP. The peak OASDHI surplus occurs in the next few years at about 0.85 percent of GNP, and the outyear combined deficits are slightly over 3 percent of GNP.

Macroeconomic Impact

The Brookings and the Lewin-ICF papers reach broadly similar conclusions concerning the key elements of the macroeconomic impact of a trust fund build-up. Some of these are straightforward; others are quite surprising. One of the most interesting points is that the impact of the trust fund build-up has little to do with Social Security, and is instead primarily dependent on how other elements of the economy act or react.

One commonly hears that the trust fund build-up is designed to pay for the retirement benefits of the large baby-boom generation. Of course, the trust funds themselves do not represent real goods and services to be consumed by future retirees. What is meant by the statement is that the OASDI surplus is expected to increase government saving, which in turn is expected to increase national saving, investment, productivity and real output. Under such conditions, future real benefits would be paid out of the increased real output of the economy, without lowering the real income of future workers. Whether this scenario plays out as stated, however, depends on many factors, which are analyzed in depth by Brookings and ICF.

Government Saving.

Both studies conclude that the effect of the OASDI Trust Fund build-up on the economy depends heavily on the overall fiscal behavior of the government. ICF states:

> The accumulation of Treasury obligations by the OASDI trust funds, in itself, will not provide real resources to pay future benefits nor directly affect the economy. If the current and projected OASDI surpluses are used to finance other government spending, and there is no increase in net government savings, the surpluses will not contribute to the accumulation of real resources that could be used to fund future social security outlays.

Because of the demographic configuration, major increases in both OASDI and Medicare expenditures will be required in the 21st century. The burden of those expenditures must be born by the working population at that time. If those future workers are to be endowed with increased resources to help them bear that burden, current savings and capital accumulation must be increased.

ICF and Brookings ran scenarios in which the OASDI surpluses financed portions of other government spending for the next 25 to 30 years, followed by a period in which OASDI deficits were financed by non-OASDI surpluses. This yielded results only slightly better than the baseline Alternative II-B projections for GNP, productivity and wages.

Both studies then ran other scenarios in which the non-OASDI budget balance was stabilized so that movements in OASDI trust fund surpluses and deficits were reflected dollar for dollar in changes in government saving. (Brookings assumed that policy changes would reduce the non-OASDI budget deficit to 1.5 percent of GNP in the 1990s and stabilize it at that level. ICF assumed the non-OASDI budget would be balanced.) In other words, both scenarios assumed that the trust fund build-up would be allowed to increase government saving through about 2030, after which the trust fund drawdown would reduce government saving.

National Saving.

Net changes in government saving have the potential to affect GNP. However, both studies point out that an increase in government saving might not translate into increased capital formation, due to reduced private saving. ICF suggests that a complementary set of policies to promote saving and investment would be required to ensure the desired outcome.

It is widely accepted that movements in government saving are commonly offset to some greater or lesser degree by counter-movements in private sector saving, thereby reducing the effect on national saving. The studies give several reasons.

- Higher taxes may reduce disposable income and saving directly.
- A reduced budget deficit, if it has adverse demand effects on the economy, may reduce growth, income and saving.
- Higher capital formation, if it occurs, may reduce the rate of return on capital, lower interest rates, and reduce saving insofar as saving is interest sensitive.
- A lower rate of return on capital domestically might result in some additional saving being diverted abroad, reducing the domestic capital build-up.

- Taxpayers may see the drop in the Government deficit as relief from the prospect of higher future taxes. This would increase perceived "permanent income" and lead to greater private consumption (the Barro effect).

A recent study (The Impact of Government Deficits on Personal and National Saving Rates) by Darby, Gillingham and Greenlees of the Office of Economic Policy, U.S. Treasury, supports this concern. The study also notes that the degree to which a reduction in the Federal deficit is offset by lower private saving is sensitive to the method of deficit reduction, at least in the short term.

- The study found that after one year, a $1 increase in taxes, holding government spending constant, leads to roughly a $0.20 increase in national saving because the $1 increase in government saving (decrease in the government deficit) is offset by an $0.80 decline in private saving. In other words, national saving increases as a result of a tax increase by only the 20-cents-on-the-dollar consumer expenditure cut which it induces.

- In contrast, a $1 decrease in government spending, holding taxes constant, would cause a much larger $0.80 increase in national saving. Specifically, after one year, the spending decrease increases government saving by $1 which would be offset by only a $0.20 increase in consumption and decline in private saving, thus increasing national saving by $0.80.

- Although these two fiscal actions have the same impact on the budget deficit, a spending decrease has approximately four times the short-run impact on national savings of a tax increase.

Higher Investment and Capital Formation.

Assuming no adverse saving offset, the Brookings and Lewin-ICF studies went on to demonstrate that if national capital accumulation were increased by an amount equal to the OASDI Trust Fund accumulation, the productivity, output, and income of the economy would increase. According to ICF,

> If additional capital investment matches the trust fund accumulation during this period, GNP could be increased by two to four percent, compared to what it would be with no additional investment. The greater capital stock and national output could help fund the greater outlays that will be required after 2020 by (1) permitting a greater level of consumption out of current income, and (2) permitting an increase in consumption at the cost of a reduction in capital

accumulation during the period when the trust fund is being drawn down to finance outlays.

Longer Term Consequences.

Both studies make the surprising point that, under these assumptions, OASDI Trust Fund accumulation and increased national capital accumulation will not significantly help the long term OASDI financing problem, if existing tax and benefit provisions are not changed.

ICF states, "Increased capital accumulation would increase national output and income and increase the level of real resources that can be used to pay the increased OASDI outlays. However, under existing OASDI tax and benefit provisions, increased national income generated by domestic investment will not improve the long term OASDI financial imbalances."

This non-intuitive result, emphasized both by Brookings and ICF, comes from a peculiar feature of the tax and benefit provisions of the OASDI System. Both tax revenues and benefit levels earned by newly retired workers are linked to wages. (The benefit formula is described in Appendix D of the OASDI Report.) As higher saving and investment rates improve productivity, real wages will rise. Higher wages result in higher tax receipts very quickly, improving the OASDI balance. However, the higher wages result in higher benefit levels, in the same proportion, about 15 to 20 years later. Because benefits exceed income under current assumptions, an equal percent increase in wages, revenues and benefits ultimately would raise the OASDI deficit. Furthermore, the assumed lower interest rates accompanying the higher capital stock will reduce OASDI interest earnings and trust fund balances over the period relative to the baseline, resulting in an even greater degree of dissaving toward the end of the period, and a faster trust fund drawdown.

Both papers indicate that a faster trust fund drawdown, and larger national dissaving, should they materialize mechanically in this fashion, could ultimately depress the capital stock and GNP below the baseline projections. Consequently, the improvements in the economy would be temporary. This conclusion is based on the admittedly unrealistic assumption built into the presentations for expositional purposes that Congress would permit the trust funds to become exhausted in this fashion, and permit the unified budget to deteriorate. It also assumes that the improvement in the rest of the budget due to faster growth and lower interest outlays would automatically be spent.

- An illustration of the link between wages and benefits is provided in Table 7. The wage-linked benefit formula provides a nearly constant replacement rate (benefits as a percent of preretirement income) over the next 75 years for retired workers who earned the average wage. There will be some adjustments to upper income replacement rates

due to the sharp increase in the maximum covered wage in the 1977 Amendments, resulting in an increase in upper income replacement rates through 2015. Thereafter, upper income replacement rates will stabilize.

- Between 1988 and 2065, the real wage of the average wage worker in the year prior to age 65 retirement will rise 175 percent in real terms, from $18,553 for the 1988 retiree to $50,934 for the 2065 retiree (all in real 1988 dollars). The benefit upon first retiring, assuming the worker had always earned the average wage and worked full time, will rise 169 percent (closely matching the 175 percent rise in real wages), from $7,534 for the 1988 retiree to $20,303 for the 2065 retiree (in real 1988 dollars). For a married worker with a spouse receiving spousal benefits, these figures would be 50 percent larger, or $11,301 in 1988 and $30,455 in 2065 (in real 1988 dollars).

- A single worker who has always earned the maximum covered wage would have real wages in the year before age 65 retirement of $45,508 for the 1988 retiree and $120,233 for the 2065 retiree (all in 1988 dollars), up 164 percent, and benefits of $10,095 in 1988 versus $31,990 in 2065 (in 1988 dollars), a difference of 217 percent in real terms. For a couple with spousal benefit, the benefits in real 1988 dollars would be $15,143 in 1988 and $47,985 in 2065.

- Faster real wage growth than assumed in Alternative II-B would push real benefits up proportionally, and widen projected long run deficits.

Uncertainty.

It should be emphasized that the Brookings and ICF projections of a weaker GNP 50 to 75 years from now are subject to great uncertainty. They depend heavily on the assumption that an accelerated trust fund drawdown will be permitted to reduce national saving in the distant future below the baseline projection. However, it is unlikely that the non-OASDI deficit will be held strictly to the paths assumed in the two studies, and it is certain that Congress will act to restore solvency to the trust funds before they are exhausted. Thus, there are steps that could be taken to preserve the stronger economy and prevent the projected trust fund drawdown from depressing saving and per capita GNP. The non-OASDI budget could be allowed to move into greater surplus, boosted by the stronger assumed GNP and lower interest rates, as the OASDI program begins to run deficits in the outyears, or the OASDI balance could be improved through tax changes, alteration of the benefit formula, or changes in retirement age or other parameters of the program.

9

Investing the Trust Funds

Under current law, OASDI receipts in excess of amounts needed for benefit payments are invested in U.S. Government securities. For the most part, these are special, non-marketable Treasury securities which are sold only to the trust funds, and which by law pay interest at the average rate on marketable Treasury securities outstanding with four years or more to maturity. Unlike ordinary securities, these special securities may always be redeemed at par. This provision shelters the trust funds from the risk of price fluctuations in the event that market interest rates change. The funds may also invest in ordinary marketable Treasury securities, or other securities guaranteed as to principle and interest by the United States.

During the period of trust fund build-up, the OASDI trust funds have the potential to absorb most or all of the outstanding and projected Treasury obligations held by the public. Other things equal, this debt would then be reissued to the public as the trust funds were drawn down during subsequent periods of deficit.

If the non-OASDI portion of the budget were to run deficits averaging 1.5 to 2.0 percent of GNP over the next 40 years (roughly equal to the post World War II average of 1.7 percent), the share of Treasury obligations in the hands of the public would be greatly diminished, but the public's holdings would probably not be eliminated entirely. If the non-OASDI budget were balanced, or brought close to balance, then the trust fund build-up could eliminate holdings of Treasury securities by the public for some period of time.

A sharp reduction in Treasury debt held by the public could result in some reduction in interest rates paid on Treasury debt. However, there is a wide range of securities which are reasonably close substitutes for one another, and it is unlikely that a sharp skewing of interest rates would occur. The financial markets could cope with a markedly lower share of Treasury securities in the total pool of financial instruments. Lewin-ICF points out that the share of Treasuries in total credit market paper has fluctuated widely over the last 40 years with little impact on interest rates.

Nonetheless, ICF recommends that Treasury securities should not be eliminated entirely, because of their useful characteristics of low risk, liquidity and diversity of maturities, traits of particular importance to many fiduciary institutions. ICF suggests that, if the need should arise, the trust funds might obtain securities of other Federal agencies, or that additional special assets could be created for the trust funds without eliminating all marketable Treasury securities. Both Brookings and ICF point to the rising volume of government guaranteed mortgage instruments, such as GNMA securities, as possible investment alternatives for the trust funds. These securities

will expand in volume as the economy grows, and could provide a large pool of safe securities should the trust funds show signs of absorbing an excessive share of Treasury obligations.

A substantial portion of Treasury securities is held by the Federal Reserve. The Fed manages monetary policy by injecting or withdrawing bank reserves by buying or selling these securities. The Fed prefers to deal in a very liquid market where its activities create the minimum disruption, and finds the Treasury bill market ideal. Nonetheless, the Fed has the authority to deal in a wide range of securities, and would not face insurmountable obstacles in the event of a sharp reduction in the supply of Treasury obligations.

Neither Brookings nor Lewin-ICF sees much economic impact from alternative investment strategies for the trust funds. Certainly, barring substantial improvement in the rest of the budget, such a shift would be of limited economic impact. If the trust funds were to lend to private sector borrowers instead of the Treasury, more of the Treasury debt would have to be held by the public. The trust funds would hold some of the non-Treasury securities the public would otherwise hold. Total debt, saving and capital formation would be unaffected. The public's portfolio would be somewhat less risky, the trust fund's portfolio somewhat more risky.

Aggressive movement of the funds into equities and other private securities would entail higher risk of loss or default than Treasury obligations, a risk unsuitable to the social policy goal of the programs. If ownership of equities or private sector bonds were contemplated, significant problems would arise as to potential federal control of corporations, the allocation of investment resources, and the conduct of business. We recommend against such involvement.

Conclusion

The OASDI trust fund build-up should be put into perspective with respect to GNP, inflation and projected deficits in other parts of the Social Security System and the rest of the budget, and the projected outyear deficits of OASDI.

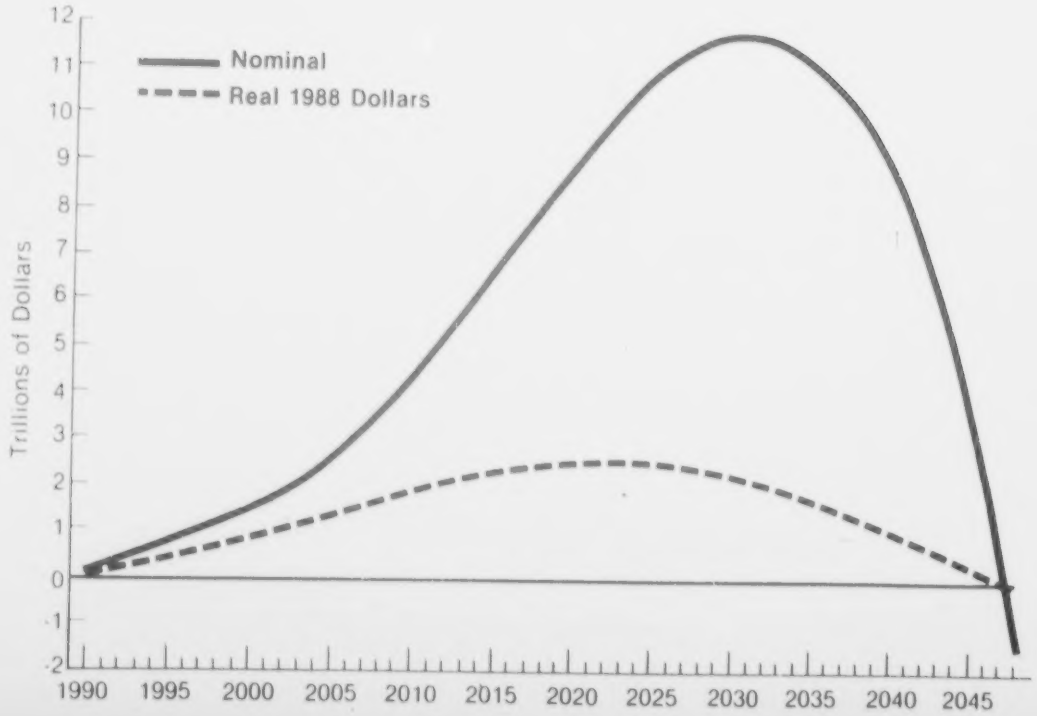
The economic impact of the trust fund surpluses will depend on what happens to the rest of the budget. According to studies by Brookings and Lewin-ICF, if the OASDI surpluses are used to finance other government outlays, little additional capital formation will occur. If the rest of the budget moves close to balance, and if the trust fund surpluses and subsequent deficits were translated into domestic saving and investment, they would first raise and then lower GNP, wages, and real output. Output could be 2 to 4 percent higher than otherwise in real terms prior to the drawdown of the trust funds in the 2030s and 2040s.

This projection could be muted by a number of factors. The changes in government saving could be largely offset by countermovements in private saving with little change in national saving. Even if national saving did rise prior to 2030, domestic capital formation would not be assured in the absence of improved tax treatment; saving might move abroad rather than raise investment in the U.S. Beyond 2030, the beneficial effects of the build-up eventually could be more than reversed by greater dissaving, and the balance of OASDI would be worsened. The earlier gains in real wages would raise real OASDI benefits via the wage-linked benefit formula, leading to higher OASDI deficits and a reduced government saving rate. This result is dependent on the assumption of a fixed deficit path in the rest of the budget, and could be altered by assuming rising surpluses in the rest of the budget, or changes in the tax rate, benefit formula, retirement age or other features of the OASDI system.

The trust fund build-up may reduce or eliminate publicly held Treasury debt, depending on what one assumes regarding the deficit of the rest of the budget. This debt would be reissued in later years of OASDI deficit. Credit markets should be able to cope with such shifts as they have in the past without major changes in interest rates. Alternatively, other investment options, such as federally backed mortgage instruments, would be a secure investment option. There is ample time to explore this issue, which may never arise in practice.

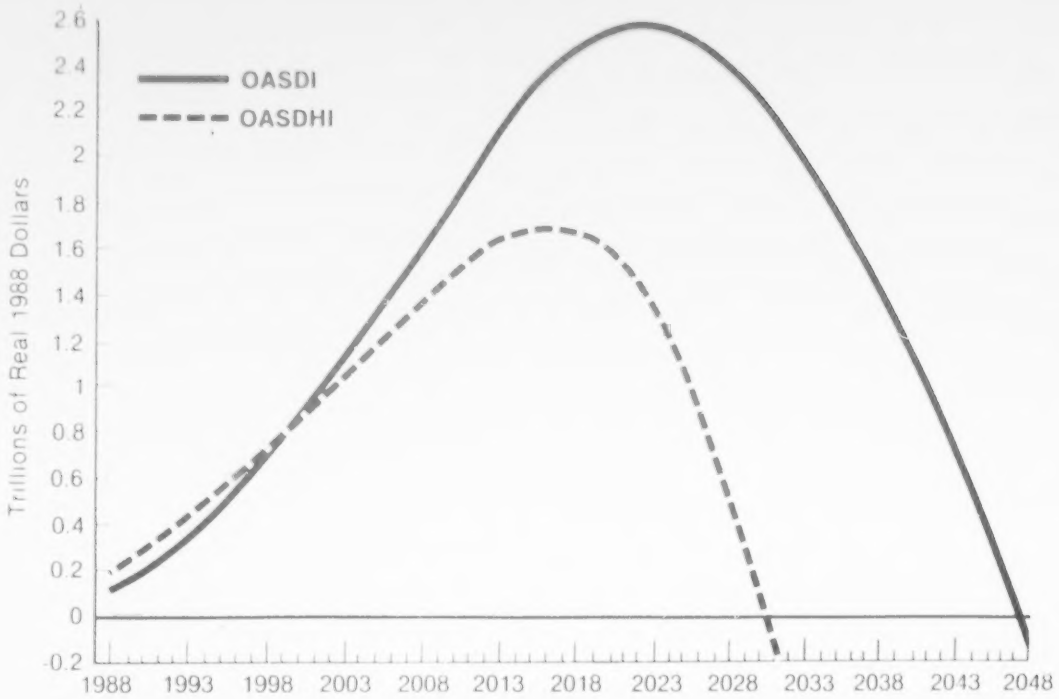
Graph 1

END OF YEAR OASDI TRUST FUND ASSETS
ALT IIB, 1988 TRUSTEES REPORT



Graph 2

REAL END OF YEAR TRUST FUND ASSETS
ALT IIB, 1988 TRUSTEES REPORT



Graph 3

OASDI and OASDHI Income and Outgo Under Present Law, 1988 Alternative II-B

(Percent of Taxable Payroll)

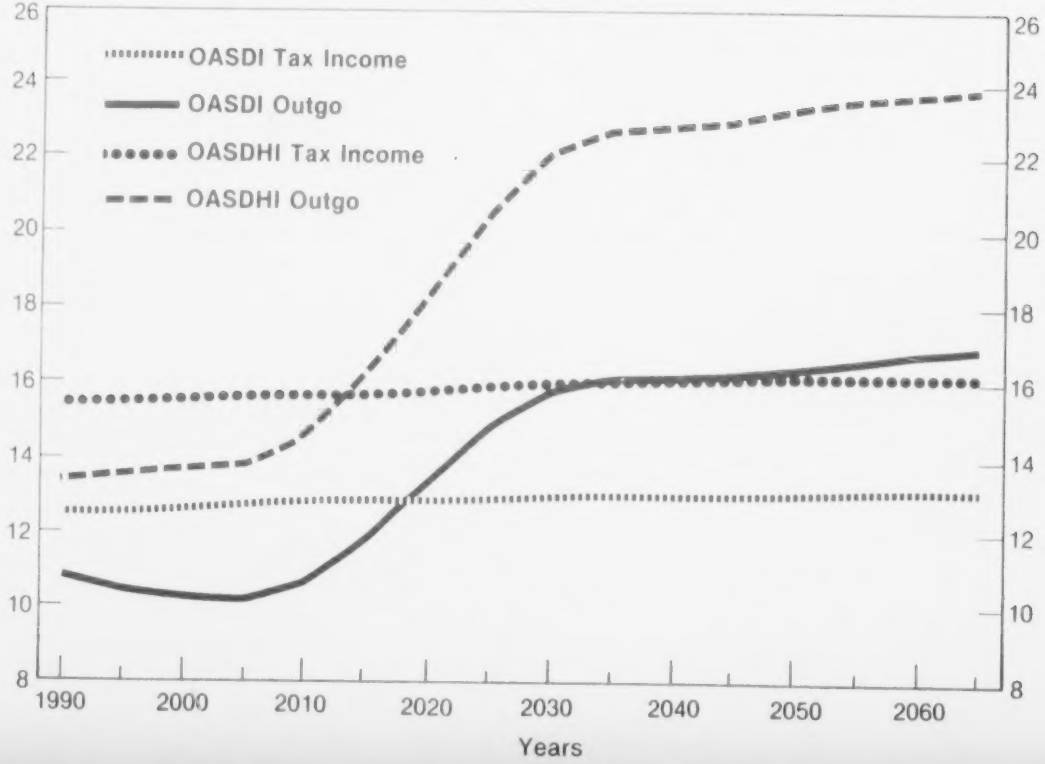


Table 1

Estimated Operations of the OASI and DI Trust Funds
(billions of dollars)

Calendar Year	Income Excluding Interest	Interest	Total Income	Total Outgo	Assets at End of Year
			Current Dollars		
1988	254.7	8.0	262.7	222.4	109.1
1990	293.3	16.3	309.5	252.2	211.9
1995	403.2	44.8	447.9	338.3	645.5
2000	547.9	83.6	631.5	446.8	1,409.4
2005	739.9	146.4	886.3	595.1	2,632.5
2010	987.4	250.5	1,237.9	825.8	4,460.6
2015	1,302.6	383.7	1,686.3	1,203.7	6,763.0
2020	1,703.0	523.2	2,226.2	1,775.4	9,124.3
2025	2,220.3	636.7	2,857.0	2,549.4	10,996.2
2030	2,898.7	692.0	3,590.7	3,524.5	11,837.5
2035	3,788.2	664.4	4,452.6	4,703.2	11,240.0
2040	4,937.8	532.8	5,470.6	6,121.7	8,840.4
2045	6,422.5	251.8	6,674.3	7,966.8	3,799.4
2050	8,349.6	-282.2	8,067.4	10,464.9	-5,744.6
2055	10,867.1	-1,238.2	9,628.9	13,797.0	-22,752.8
2060	14,159.3	-2,836.9	11,322.4	18,109.0	-51,053.9
2065	18,443.8	-5,374.2	13,069.6	23,662.1	-95,828.2
			Real (1988) Dollars		
1988	254.7	8.0	262.7	222.4	109.1
1990	268.9	14.9	283.8	231.3	193.5
1995	303.3	33.7	336.9	254.5	485.6
2000	338.7	51.7	390.4	276.2	871.3
2005	376.0	74.4	450.3	302.4	1,337.6
2010	412.4	104.6	517.0	344.9	1,863.0
2015	447.1	131.7	578.9	413.2	2,321.6
2020	480.5	147.6	628.1	500.9	2,574.4
2025	514.9	147.6	662.5	591.2	2,550.1
2030	552.5	131.9	684.4	671.8	2,256.3
2035	593.5	104.1	697.6	736.8	1,760.9
2040	635.8	68.6	704.4	788.3	1,138.4
2045	679.7	26.6	706.4	843.2	402.1
2050	726.3	-24.5	701.8	910.4	-499.7
2055	777.0	-88.5	688.5	986.5	-1,626.8
2060	832.1	-166.7	665.4	1,064.2	-3,000.3
2065	890.9	-259.6	631.3	1,143.0	-4,628.8

The top panel is from Table G1 of the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds; the lower panel is derived from the upper panel using the adjusted CPI in Table G2 of the Report.

Table 2

Estimated Operations of the OASDI and HI Trust Funds
(billions of dollars)

Calendar Year	Income Excluding Interest	Interest	Total Income	Total Outgo	Assets at end of year
			Current Dollars		
1988	317.1	15.7	332.8	276.7	200.3
1990	363.5	26.0	389.5	317.9	318.2
1995	499.6	53.2	552.8	441.5	750.0
2000	678.4	84.6	763.0	600.9	1,405.5
2005	915.4	131.5	1046.9	817.5	2,340.5
2010	1221.3	204.2	1,425.5	1,145.1	3,613.9
2015	1,609.4	283.4	1,892.8	1,662.4	4,970.0
2020	2,101.3	330.8	2,432.1	2,448.4	5,715.6
2025	2,736.4	283.2	3,019.5	3,540.6	4,745.1
2030	2,569.5	56.2	3,625.6	4,949.4	596.9
2035	4,663.0	-431.0	4,232.1	6,675.9	-8,103.9
2040	6,077.6	-1,282.5	4,795.1	8,765.7	-2,3149.3
2045	7,904.4	-2,642.5	5,261.9	11,448.3	-47,072.0
2050	10,274.5	-4,751.0	5,523.4	15,036.1	-84,118.1
2055	13,369.6	-7,725.6	5,644.0	19,805.5	-136,392.1
2060	17,417.6	-12,497.9	4,919.7	26,022.2	-220,101.4
2065	22,686.6	-19,559.8	3,126.8	34,014.5	-343,818.1
			Real (1988) Dollars		
1988	317.1	15.7	332.8	276.7	200.3
1990	333.3	23.8	357.1	291.5	291.8
1995	375.8	40.0	415.8	332.1	564.1
2000	419.4	52.3	471.7	371.1	868.9
2005	465.1	66.8	532.0	415.4	1,189.3
2010	510.1	85.3	595.4	478.3	1,509.3
2015	552.5	97.3	649.8	570.7	1,706.1
2020	592.9	93.3	686.2	690.8	1,612.6
2025	634.6	65.7	700.2	821.1	1,100.4
2030	680.4	10.7	691.1	943.4	113.8
2035	730.5	-67.5	663.0	1,045.9	-1,269.6
2040	782.6	-165.1	617.5	1,128.7	-2,980.9
2045	836.6	-279.7	556.9	1,211.7	-4,982.0
2050	893.8	-413.3	480.5	1,308.0	-7,317.5
2055	955.4	-570.4	385.6	1,416.1	-10,064.8
2060	1,023.6	-754.0	269.6	1,529.3	-13,274.8
2065	1,095.8	-966.0	129.8	1,643.0	-16,976.9

Treasury estimates derived from data underlying the 1988 Trustees Report.

Table 3

Unified Budget Impact of Projected OASDI and HI Surpluses and Deficits (Excludes Interest) in Current and Constant Dollars (Alternative II-B) (billions of dollars)

	Current Dollars			Real (1988) Dollars		
YEAR	OASDI	HI	TOTAL	OASDI	HI	TOTAL
1988	32.30	8.10	40.40	32.30	8.10	40.40
1990	41.00	4.50	45.50	37.59	4.13	41.72
1995	64.90	-6.80	58.10	48.82	-5.11	43.71
2000	101.10	-23.60	77.50	62.50	-14.59	47.91
2005	144.80	-46.90	97.90	73.58	-23.83	49.75
2010	161.60	-85.40	76.20	67.49	-35.67	31.82
2015	98.90	-151.90	-53.00	33.95	-52.14	-18.19
2020	-72.40	-274.70	-347.10	-20.43	-77.50	-97.93
2025	-329.10	-475.10	-804.20	-76.32	-110.18	-186.50
2030	-625.80	-754.10	-1379.90	-119.28	-143.74	-263.02
2035	-915.00	-1097.80	-2012.80	-143.35	171.99	-315.34
2040	-1183.90	-1504.10	-2688.00	-152.45	-193.68	-346.13
2045	-1544.30	-1999.60	-3543.90	-163.44	-211.63	-375.07
2050	-2115.30	-2646.30	-4761.60	-184.01	-230.20	-414.21
2055	-2929.90	-3506.00	-6435.90	-209.49	-250.68	-460.17
2060	-3949.70	-4654.80	-8604.50	-232.12	-273.55	-505.67
2065	-5218.30	-6109.60	-11327.90	-252.06	-295.11	-547.17

SOURCE: These figures have been derived from numbers presented in the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Tables G2 and G3; for 2065, additional information was provided by the Social Security Administration.

Table 4

Unified Budget Impact of Projected OASDI and HI Surpluses and Deficits (Excludes Interest) as Percent of Taxable Payroll and Percent of GNP (Alternative II-B)

YEAR	Percent of Payroll			Percent of GNP		
	OASDI	HI	TOTAL	OASDI	HI	TOTAL
1988	1.56	0.38	1.94	0.68	0.17	0.85
1990	1.79	0.19	1.98	0.76	0.08	0.85
1995	2.07	-0.21	1.86	0.88	-0.09	0.78
2000	2.37	-0.52	1.85	1.01	-0.23	0.77
2005	2.53	-0.78	1.75	1.07	-0.34	0.72
2010	2.53	-1.06	1.07	0.89	-0.47	0.42
2015	1.02	-1.44	-0.42	0.41	-0.63	-0.22
2020	-0.51	-2.00	-2.51	-0.23	-0.87	-1.10
2025	-1.89	-2.67	-4.56	-0.80	-1.15	-1.95
2030	-2.78	-3.26	-6.04	-1.16	-1.39	-2.55
2035	-3.12	-3.64	-6.76	-1.28	-1.54	-2.83
2040	-3.10	-3.83	-6.92	-1.26	-1.61	-2.87
2045	-3.11	-3.91	-7.02	-1.26	-1.63	-2.88
2050	-3.28	-3.99	-7.27	-1.31	-1.64	-2.95
2055	-3.50	-4.06	-7.56	-1.38	-1.66	-3.04
2060	-3.62	-4.14	-7.77	-1.42	-1.67	-3.09
2065	-3.68	-4.18	-7.85	-1.43	-1.67	-3.10

SOURCE: OASDI and HI percentages were obtained from the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Tables 26 and E3; respectively. Additional information, for 2065, was provided by the Social Security Administration.

Table 5

CONTRIBUTION RATES FOR THE OASDI AND HI PROGRAMS

Calendar years	Contribution rates (percent)					
	Employees and employers, combined			Self-employed		
	OASDI	HI	Total	OASDI	HI	Total
1966	7.70	0.70	8.40	5.80	0.35	6.15
1967	7.80	1.00	8.80	5.90	0.50	6.40
1968	7.60	1.20	8.80	5.80	0.60	6.40
1969-70	8.40	1.20	9.60	6.30	0.60	6.90
1971-72	9.20	1.20	10.40	6.90	0.60	7.50
1973	9.70	2.00	11.70	7.00	1.00	8.00
1974-77	9.90	1.80	11.70	7.00	0.90	7.90
1978	10.10	2.00	12.10	7.10	1.00	8.10
1979-80	10.16	2.10	12.26	7.05	1.05	8.10
1981	10.70	2.60	13.30	8.00	1.30	9.30
1982-1983	10.80	2.60	13.40	8.05	1.30	9.35
1984[1]	11.40	2.60	14.00	11.40	2.60	14.00
1985[1]	11.40	2.70	14.10	11.40	2.70	14.10
1986-1987[1]	11.40	2.90	14.30	11.40	2.90	14.30
1988-89[1]	12.12	2.90	15.02	12.12	2.90	15.02
1990 and later	12.40	2.90	15.30	12.40	2.90	15.30

[1]See section entitled "Nature of the Trust Funds", OASDI Trustees Report, for description of tax credits allowed against the combined OASDI and HI taxes on net earnings from self-employment in 1984-89.

TABLE 6—COMPARISON OF ESTIMATED TOTAL INCOME RATES AND COST RATES FOR THE OASI, DI, AND HI PROGRAMS, BY ALTERNATIVE, CALENDAR YEARS 1988-2060
(As a percentage of taxable payroll[1])

Calendar year	Total income rate	Cost rate				Balance[2]
		OASI	DI	HI[3]	Total	
Alternative I						
1988	15.19	9.58	1.06	2.50	13.13	2.06
1989	15.27	9.46	1.04	2.51	13.01	2.19
1990	15.48	9.39	1.01	2.59	13.00	2.48
1991	15.50	9.27	.98	2.63	12.93	2.61
1992	15.50	9.15	.98	2.66	12.78	2.72
1993	15.50	9.03	.97	2.68	12.65	2.85
1994	15.50	8.87	.96	2.70	12.53	2.97
1995	15.50	8.75	.97	2.72	12.44	3.06
1996	15.50	8.63	.97	2.74	12.34	3.15
1997	15.50	8.53	.98	2.74	12.25	3.24
2000	15.54	8.17	1.01	2.75	11.92	3.61
2005	15.59	7.78	1.09	2.70	11.56	4.02
2010	15.63	7.60	1.22	2.67	11.79	3.84
2015	15.69	8.75	1.29	2.67	12.71	2.98
2020	15.78	9.93	1.32	2.78	14.04	1.72
2025	15.81	10.82	1.28	2.68	14.78	.03
2030	15.84	11.27	1.25	2.57	15.79	.05
2035	15.85	11.23	1.31	2.45	15.85	.00
2040	15.84	10.87	1.30	2.40	15.57	.27
2045	15.83	10.55	1.32	2.44	15.32	.51
2050	15.83	10.42	1.33	2.49	15.23	.60
2055	15.83	10.37	1.32	2.52	15.21	.62
2060	15.83	10.29	1.31	2.56	15.16	.67
Alternative I-A						
1988	15.19	9.81	1.08	2.51	13.41	1.78
1989	15.20	9.55	1.07	2.56	13.18	2.03
1990	15.48	9.57	1.05	2.68	13.30	2.19
1991	15.50	9.46	1.04	2.75	13.28	2.22
1992	15.50	9.40	1.03	2.82	13.25	2.26
1993	15.51	9.31	1.03	2.89	13.24	2.27
1994	15.51	9.23	1.04	2.96	13.23	2.28
1995	15.51	9.15	1.05	3.03	13.22	2.28
1996	15.51	9.06	1.06	3.10	13.22	2.29
1997	15.51	8.99	1.08	3.15	13.22	2.29
2000	15.56	8.73	1.12	3.31	13.17	2.39
2005	15.62	8.44	1.26	3.53	13.23	2.39
2010	15.78	8.58	1.44	3.77	13.80	1.98
2015	15.74	9.74	1.55	4.12	15.39	.36
2020	15.83	11.18	1.60	4.66	17.44	-1.62
2025	15.90	12.45	1.59	5.29	19.44	-3.53
2030	15.95	13.32	1.68	5.85	20.85	-4.90
2035	15.98	13.65	1.85	6.22	21.51	-5.53
2040	15.98	13.60	1.93	6.40	21.93	-5.96
2045	15.99	13.54	1.71	6.48	21.74	-5.75
2050	16.00	13.75	1.74	6.55	22.06	-6.06
2055	16.02	13.93	1.73	6.63	22.29	-6.27
2060	16.02	14.07	1.72	6.70	22.49	-6.46

Calendar year	Total income rate	Cost rate				Balance[2]
		OASI	DI	HI[3]	Total	
Alternative II-B						
1988	15.19	9.65	1.08	2.52	13.25	1.94
1989	15.20	9.55	1.08	2.58	13.30	1.90
1990	15.50	9.74	1.07	2.71	13.52	1.98
1991	15.51	9.73	1.07	2.80	13.60	1.91
1992	15.52	9.68	1.06	2.88	13.62	1.89
1993	15.52	9.62	1.06	2.95	13.63	1.89
1994	15.52	9.54	1.07	3.03	13.64	1.88
1995	15.52	9.47	1.07	3.11	13.65	1.86
1996	15.52	9.40	1.09	3.18	13.66	1.86
1997	15.52	9.33	1.10	3.23	13.66	1.85
2000	15.57	9.13	1.16	3.42	13.72	1.85
2005	15.65	8.91	1.31	3.68	13.89	1.75
2010	15.71	9.18	1.49	3.95	14.63	1.07
2015	15.78	10.26	1.60	4.34	16.20	-.42
2020	15.87	11.81	1.66	4.90	18.37	-2.51
2025	15.94	13.18	1.76	5.57	20.50	-4.56
2030	16.00	14.14	1.74	6.16	22.04	-6.04
2035	16.03	14.54	1.71	6.54	22.79	-6.76
2040	16.03	14.52	1.71	6.73	22.96	-6.92
2045	16.04	14.47	1.78	6.81	23.06	-7.02
2050	16.05	14.53	1.80	6.84	23.32	-7.27
2055	16.06	14.86	1.80	6.96	23.62	-7.56
2060	16.07	15.02	1.78	7.04	23.84	-7.77
Alternative III						
1988	15.19	9.80	1.13	2.56	13.49	1.71
1989	15.21	10.02	1.16	2.67	13.86	1.35
1990	15.53	10.19	1.17	2.85	14.21	1.32
1991	15.52	10.33	1.19	2.99	14.50	1.02
1992	15.54	10.59	1.24	3.16	15.09	.45
1993	15.54	10.60	1.25	3.28	15.13	.41
1994	15.54	10.52	1.27	3.43	15.22	.32
1995	15.54	10.43	1.28	3.57	15.29	.25
1996	15.54	10.37	1.31	3.71	15.40	.14
1997	15.54	10.32	1.34	3.85	15.51	.03
2000	15.61	10.18	1.40	4.31	15.89	-.28
2005	15.70	10.00	1.59	5.07	16.65	-.95
2010	15.77	10.35	1.84	5.98	18.17	-2.40
2015	15.85	11.58	2.00	7.18	20.85	-4.99
2020	15.97	13.83	2.10	8.79	24.52	-8.56
2025	16.07	15.58	2.25	10.60	28.43	-12.36
2030	16.17	17.30	2.26	12.17	31.73	-15.57
2035	16.23	18.48	2.25	13.14	33.88	-17.62
2040	16.27	19.15	2.30	13.53	34.99	-18.72
2045	16.31	19.80	2.43	13.71	35.94	-19.63
2050	16.36	20.72	2.51	13.86	37.08	-20.72
2055	16.42	21.74	2.51	14.01	38.26	-21.84
2060	16.48	22.57	2.48	14.17	39.22	-22.74

[1]The taxable payroll for HI is somewhat larger than the taxable payroll for OASDI, because HI covers all Federal civilian employees, including those hired before 1984, all State and local government employees hired after April 1, 1986, and railroad employees. This difference is relatively small and does not significantly affect the comparisons.

[2]Cost rates for HI exclude amounts required for trust fund maintenance.

[3]The balance is the total income rate minus the combined OASDI and HI cost rate. Negative balances are deficits.

Table 7

Projected Initial Real Benefits for Single Retirees
Age 65 with Average and Maximum Covered Earnings (Alternative II-B)

Retirement Year	Annual Benefits: Current Dollars Average	Current Dollars Maximum	Constant 1988 Dollars Average	Constant 1988 Dollars Maximum	Replacement Rate Average	Replacement Rate Maximum
1988	7,534	10,095	7,534	10,095	42.2	23.0
1990	8,621	11,690	7,905	10,719	44.0	25.1
1995	10,558	14,691	7,941	11,050	41.4	24.4
2000	13,762	19,891	8,508	12,297	41.4	25.3
2005	17,907	26,827	9,099	13,632	41.4	26.2
2010	23,291	35,931	9,727	15,006	41.4	27.1
2015	30,297	47,635	10,400	16,352	41.4	27.6
2020	39,415	62,214	11,121	17,553	41.4	27.7
2025	51,277	80,942	11,891	18,771	41.5	27.7
2030	66,704	105,292	12,714	20,069	41.5	27.7
2035	86,769	136,776	13,594	21,428	41.5	27.7
2040	112,866	177,910	14,534	22,909	41.5	27.7
2045	146,811	231,374	15,538	24,488	41.5	27.7
2050	190,964	300,899	16,612	26,175	41.5	27.7
2055	248,410	391,411	17,761	27,986	41.5	27.7
2060	323,127	509,142	18,989	29,921	41.5	27.7
2065	420,320	662,284	20,303	31,990	41.5	27.7

Assumes retirement at age 65. Beneficiaries are assumed to have been full time workers earning the average wage in covered employment, or the maximum covered wage throughout their working lives. Married couples with a spousal benefit would receive 150 percent of the amounts shown in the table. Data were provided by the Social Security Administration.

STUDY OF THE POTENTIAL ECONOMIC AND FISCAL EFFECTS OF INVESTMENT OF THE ASSETS OF THE SOCIAL SECURITY OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS

FINAL REPORT

Submitted to:
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May 1988

CHAPTER SIX

CONCLUSIONS

This chapter summarizes several of the major conclusions of the study.

1. **The Effect of OASDI Trust Fund Accumulation on the Economy and on the Ability of the OASDI System to Fund Future Benefits Depends on the Overall Fiscal Behavior of the Government.**

The accumulation of Treasury obligations by the OASDI trust funds, in itself, will not provide real resources to pay future benefits nor directly affect the economy. If the current and projected OASDI surpluses are used to finance other government spending, and there is no increase in net government savings, the surpluses will not contribute to the accumulation of real resources that could be used to fund future social security outlays.

Because of the demographic configuration, major increases in both OASDI and Medicare expenditures will be required in the 21st century. The burden of those expenditures must be born by the working population at that time. If those future workers are to be endowed with increased resources to help them bear that burden, current savings and capital accumulation must be increased.

Increasing real government savings will require significant changes in non-OASDI taxes and expenditures. The changes required to balance non-OASDI federal accounts are illustrated by comparing Scenario 1 described in Chapter 3 with Scenarios 4 or 7. In Scenario 4, for example, non-OASDI taxes are increased by 1.4 percent of GNP, non-OASDI outlays are reduced by 1.4 percent of GNP, the Medicare HI payroll tax is increased to 3.9 percent of payroll, and HI outlays are reduced by 20 percent. These major changes are phased in over the period 1991-1995 in order to balance the federal budget by 1997.

2. Even if Federal Deficits Are Reduced Significantly and Federal Government Savings Are Increased, Private Capital Accumulation Is Not Assured.

Increased government savings could be offset by increased private consumption. If the accumulation of large OASDI trust funds, and the corresponding government savings, is to help fund future OASDI outlays, a complementary set of policies to promote -- or at least to avoid penalizing -- private savings and investment is required. The large requirements for retirement income and for health care that will be associated with the significant increases in the elderly population that will occur in the next century mandates the current importance of these issues.

3. If National Capital Accumulation Is Increased by an Amount Equal to the OASDI Trust Fund Accumulation, the Productivity, Output, and Income of the Economy Would Increase.

The size of the OASDI trust fund is projected to be greater than 25 percent of GNP during the period 2012-2026. If additional capital investment matches the trust fund accumulation during this period, GNP could be increased by two to four percent, compared to what it would be with no additional investment. (Alternative macroeconomic model estimates are presented in Table 4-1 and Table 4-11 in Chapter 4.) The greater capital stock and national output could help fund the greater OASDI outlays that will be required after 2020 by (1) permitting a greater level of consumption out of current income, and (2) permitting an increase in consumption at the cost of a reduction in capital accumulation during the period when the trust fund is being drawn down to finance outlays.

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4. **OASDI Trust Fund Accumulation and Increased National Capital Accumulation Will Not Significantly Help the Long Term OASDI Financing Problem if Existing Tax and Benefit Provisions Are Not Changed.**

Increased capital accumulation would increase national output and income and increase the level of real resources that can be used to pay the increased OASDI outlays. However, under existing OASDI tax and benefit provisions, increased national income generated by domestic investment will not improve the long term OASDI financial imbalances. Two factors are at work. (1) Increased domestic investment will increase average wages. Increased wages will increase tax revenues immediately but will increase benefits equally, after a short lag. At first the projected OASDI surpluses will be increased, but after about 2025 the projected deficits will be increased. Ultimately, benefit payments will be increased more than tax revenues. (2) The increased capital intensity of the economy will reduce the rate of return to capital and will reduce the interest earned on the trust fund balances. Interest rates could be reduced by five to six percent during the period 2015-2025 when the trust fund is greatest. Both the increase in wages and the reduction in interest rates reflect the increased income and productivity of the economy, and hence an increase in economic well-being. Nevertheless, under the current OASDI financing and benefit calculation provisions, they hurt the long run financial balance of the system.

5. **Finding an Alternative to Treasury Securities for Investment of the OASDI Trust Funds Is Not a High Priority, Especially for the Next Two Decades.**

The possibility that the OASDI trust funds could acquire all marketable Treasury securities is of interest, but is not a current concern. First, it will not happen soon, if at all. The earliest that outstanding marketable

federal debt could be eliminated, under our most severe fiscal scenario, is 2008. Second, a significant reduction in the proportion of total financial assets accounted for by Treasury securities is unlikely to affect significantly the functioning of financial markets, interest rates, or the conduct of monetary policy. The share of financial assets accounted for by Treasury securities has varied greatly over the past forty years with no apparent effect on interest rates (as shown in Figures 5-1 and 5-2 of Chapter 5). Third, in the unlikely case that the federal government maintains budget surpluses long enough to eliminate net government debt, other assets could be created (or existing federal agency assets could be increased) for the Treasury or the OASDI trust funds to hold, without disrupting financial markets.

6. Because of the Useful Role They Play in Financial Markets, Treasury Securities Should Not Be Eliminated.

Treasury securities have unique features, in terms of risk, liquidity, diversity of maturities, they are widely held, and they play an important role in world financial markets. Consequently, they should not be eliminated. Other assets should be created for the Treasury or the OASDI trust funds to hold, rather than eliminating all marketable Treasury securities. These assets could be designed to provide for the trust funds the desirable features that Treasury securities provide.

7. There Are No Alternatives to Current OASDI Trust Fund Investment Policy that Would Provide a Meaningful Improvement in Investment Performance.

No alternative assets would provide an obvious improvement in the risk-return characteristics of the OASDI trust funds, nor should that be the focus of social security trust fund investment policy. The social security

system represents a major social commitment and a major element of social policy, and it plays a major role in the economy. The focus of social security investment policy should be (1) the overall long term productivity of the economy, and (2) intergenerational and intragenerational equity. The OASDI system may affect the long term productivity of the economy through influencing the savings-consumption mix. This mix should be consistent with accepted views of intergenerational equity.

An increased return on a portfolio of investments can be achieved only by increasing the risk. A key issue is who bears the risk of the social security system. Historically, beneficiaries have not born the risk. The risk that revenues will not match what is expected or required to pay promised benefits has been born by all taxpayers, through the federal budget. If the risk is born by all citizens, the best investment policy for the social security system is to seek to maximize the aggregate rate of return to capital and therefore the productivity of the economy. The focus of OASDI trust fund investment policy should be the long term productivity of the economy. It may be that assets could be acquired by the OASDI trust fund which have a greater expected return, in exchange for bearing greater risk. Such a policy would simply redistribute the composition of assets and risk in the economy. It would not change the overall productivity of the economy or the aggregate rate of return.

FINAL REPORT

TO

SOCIAL SECURITY ADMINISTRATION
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

ON

CONTRACT NO. 600-87-0072

TO

THE BROOKINGS INSTITUTION

Principal Investigators

Henry J. Aaron
Barry P. Bosworth
Gary T. Burtless

LESSONS TO BE LEARNED

The major lessons of this study can be summarized briefly.

[1] Growth of total factor productivity in the nonfarm business sector must be quite high by historical standards if real wages are to grow at the rate assumed in the IIB projections. From 1947 through 1973, total factor productivity in the nonfarm business sector grew 14 percent per decade. This rate slumped to just 7 percent between 1975 and 1985. Under our assumptions about the growth of productivity on farms and in the government and institutional sectors and about sectoral shifts, total factor productivity within nonfarm business must grow 13 to 16 percent per decade to meet the IIB assumption about real wage growth over the next 75 years.

[2] To replicate the detailed IIB projection of future trust fund balances, we are forced to accept the Social Security Administration's exact projection of future interest rates on federal Treasury debt. The interest rates projected by the Social Security Administration are not entirely consistent with our neoclassical growth model. The rise in worker productivity over the projection period arises partly from capital deepening--that is, a growing level of investment in capital per worker. As capital per worker rises, and with it the ratio of capital stock to nonfarm output, we would expect a decline in the rate of return on capital and a corresponding drop in the rate of return on financial

assets--such as Treasury debt. This decline should persist long after 1995, the year in which the IIB projection assumes the real return on the trust fund will stabilize. On the other hand, the IIB projections are based on the assumption that the real rate of interest (adjusted for inflation) will fall sharply from its current level of 5 percent to a constant 2 percent over the last 65 years of the projection period.

[3] The projections of future trust fund balances and solvency are highly sensitive to the assumed rate of interest. If the real rate of return on the trust fund is just one percentage point higher than assumed in the IIB projections, the reserve position in 2060 is changed from a deficit equal to 9.7 percent of GNP in that year to a surplus equal to 4.3 percent of GNP. Because projections are so acutely sensitive to the interest rate, our simulation results depend on how we assume the interest rate on the trust fund moves when the rate of return on capital changes. We assume that a proportional change in the real, after-corporate-tax rate of return on reproducible capital causes a proportional change in the real interest rate on the trust fund balance. (The real, after-corporate-tax rate of return is measured as a ten-year moving average, so the interest rate on the trust fund responds with a lag to changes in the real return on capital.) In our baseline simulation we assume that the IIB projection of interest rates on the trust fund is exactly correct.

[4] When a shift in policy changes the capital stock from the baseline projection, productivity and the real wage change immediately. The rise in wages will be proportionately smaller than the rise in the size of the capital stock, but the effect on wages is nonetheless immediate. The rise in wages leads to an instantaneous and equal proportional rise in social security payroll taxes.

[5] Because of the social security indexing formula, a rise in real wages is followed in 15-20 years by a proportionately equal rise in benefits. Until this 15-20 year interval has elapsed, payroll tax revenues will have risen by proportionately more than benefit outlays, so the balance of [Taxes - Benefit Outlays] has probably improved. If the interest rate earned on the trust fund were unchanged, the trust fund reserve at the end of this period would therefore be increased, because the social security surplus in each year over the period is larger or the deficit is smaller.

[6] Twenty years after an increase in real wages, benefits and tax revenues will have risen by equal proportionate amounts. The change in the annual net balance of social security (revenues minus outlays) depends upon the baseline position of this net balance. If taxes exceed benefits in the baseline, a proportionate increase in both improves the balance. However, in periods when baseline benefits exceed taxes, a proportionate increase in both only worsens the annual balance.

[7] Any federal fiscal policy that raises national saving and leads to a deepening of the domestic capital stock will tend to reduce the real rate of return on nonfarm business investment. A drop in real rates of return will tend to reduce the real interest rate on federal Treasury debt and, hence, on the trust fund reserve. A policy that reduces real interest on the trust fund without affecting the year-to-year balance of [Taxes - Benefit Outlays] must harm the long-term solvency of the system.

[8] If a nonOASDI fiscal policy is adopted that permits swings in the social security surplus to be fully reflected as swings in national saving and domestic investment, domestic investment will initially rise but ultimately fall below the level it would otherwise have been. Because the social security surplus is large and positive through the year 2030, investment will be raised through that year; because the surplus disappears in subsequent years, investment will be lowered thereafter.

[9] The policy just mentioned will first raise the capital stock, worker productivity, wages, and social security taxes above the level they would otherwise have been. But by the end of the projection period, the capital stock, productivity, wages, and social security revenues will be lower than they would have been under a policy that fixed the overall federal deficit as a constant share of GNP. (The capital stock must ultimately be reduced because over the entire 75-year pro-

jection period the trust fund faces a small deficit.) This pattern implies that the solvency of the social security system itself will be harmed by a fiscal policy that first raises but ultimately reduces the rate of national saving and domestic investment.

[10] The effect of the social security surplus on financial markets and the economy depends critically on the budget policy of the remainder of the federal government. If the deficit in the general fund account is small enough, national saving and investment could rise well above the levels projected in our baseline, with obvious effects on productivity, real wages, and social security benefits. However, these gains to the real economy result in only temporary gains to the social security system itself. Ultimately, benefits rise by a greater absolute amount than tax revenues, leading to a larger long-run deficit under current assumptions about the real interest rate earned on the trust fund.

[11] International investment reduces growth of the domestic capital stock, output, wages, and social security tax revenues. Because some national saving is invested abroad rather than at home, the capital stock and worker productivity fail to rise as fast as they would if all saving were invested domestically.

[12] Given the trust fund build-up indicated by the IIB projections, the burden of social security on the economy will be reduced. The near-term social security surplus will be smaller than it would be

if all saving is invested at home. On the other hand, the rate of return earned on the trust fund will be higher, because the smaller domestic capital stock (in our model) leads to a higher domestic interest rate. Ultimately, social security benefits absorb a smaller percentage of net and gross national income, because the investment of the social security surplus abroad does not raise domestic productivity and wages, and hence does not increase social security benefits.

[13] If one believes that the aggregate saving rate will vary with changes in the age-composition of the population, the private saving rate should rise over the next three decades because of a decline in the proportion of the population in the age bracket that dissaves--young adults under age 35. Depending upon our assumption about the saving rate among people over age 65, the aggregate saving rate over the entire projection period will remain above the rate of the last decade. Hence, the private saving rate should be higher than the rate we assume in our baseline projection. A higher private saving rate would tend to reinforce the effects of short- or long-term changes in the government saving rate. This conclusion follows from the fact that a given percentage change in gross national product resulting from a change in fiscal policy will cause a bigger swing in private saving, leading in turn to larger proportional effect on investment, the capital stock or foreign investment, and worker productivity or national income earned on foreign assets.

[14] If private saving rises with the real interest rate, the real economic effects of any given change in fiscal policy or social security investment policy will be smaller than they would be if private saving did not respond to changes in the rate of interest.

[15] The assumption of a lower elasticity of substitution of capital for labor does not produce interesting (or convincing) results.

[16] Contrary to the fears of some analysts, we find that available financial assets--Treasury debt, corporate bonds, residential mortgages, state and local bonds--are close substitutes for one another. The relative interest rates on these assets have fluctuated within narrow bounds in spite of the wide variation over time in the market availability of different types of assets. Hence, we doubt that a sharp decline in the availability of Treasury debt will substantially affect the functioning of financial markets.

[17] For several reasons it would be convenient to maintain a market in short-term and highly liquid Treasury securities. Such a market would be precluded if all Treasury debt were held by the social security trust fund. Should this contingency arise--and given current fiscal policy, it seems highly unlikely it will--we suggest a policy of investing social security surpluses in federally backed securities, such as mortgage backed securities of the Government National Mortgage Associa-

tion. This type of investment does not require the OASDI Trustees to become involved in issues of corporate management.

[18] The expected yield of the trust fund would rise under this alternative policy, but the risk exposure of the fund would rise as well. The increase in risk would not be large; neither would be the expected gains. The primary issues surrounding investment in such assets would be whether such a policy would increase the likelihood that social security reserves would actually be allowed to accumulate and to add to public saving.

THE DREYFUS
CORPORATION

Thanks to the changes in the Social Security laws that were drafted by the special commission, the Social Security Trust Fund has begun to build surpluses that could grow to enormous size.

Great credit for these reforms should go to Alan Greenspan, who chaired the committee, to Senators Dole and Moynihan, and to the other members of the Commission.

It was a great accomplishment to change the financing of social security from a situation where there was real danger of the system going broke to one where truly large surpluses are now in prospect.

One would think that the changed financing outlook would be reassuring. However, it is our impression that the general public is deeply skeptical that the Social Security Trust Fund will be respected. People whom we are in touch with, typical investors and other contributors to Social Security, simply don't believe that future Congresses or Administrations will be able to keep their hands off this money. The public fears that the funds, which are supposed to be held in trust to pay social security benefits, may be diverted to other spending programs.

In effect, people are saying that they do not want anyone, whatever may be their party affiliation, to tamper with or dilute this fund for political purposes outside of its main objective, except perhaps for related health and medical programs. The public thus wants this program to be a non-partisan issue and it is of paramount importance that its primary function be fulfilled and not diverted.

My main purpose in appearing here today is to urge that the Congress take action to defend the integrity of the Social Security

MANAGERS OF THE DREYFUS GROUP OF MUTUAL INVESTMENT FUNDS
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Trust Fund. It is important that the size of the surplus funds be clearly delineated and not presented in the budget process in a manner that would conceal it in overall budgetary programs. People have a right to know how their Social Security savings are being or will be utilized.

There can be many benefits from accumulating a surplus in the Social Security Trust Fund. First and foremost, of course, will be the ability of the Fund to pay its obligations to present and future retirees. Second, the presence of this surplus will greatly reduce the Government's need, at least for a number of years, to borrow in the long-term bond market. This of course would work to lower interest rates, which would mean lower costs for investment in productive capacity. Finally, the availability of the surplus funds will be a big factor in channeling economic resources to productivity improvement rather than to increase consumption, a change that is long overdue to make America more competitive.

None of these very desirable developments will occur, however, if the Trust Fund is diverted to other uses. Thus we think the public is absolutely right to be worried about the future integrity of the Trust Fund.

It is imperative that the integrity of the fund be preserved. Indeed one could argue that if the financial markets perceive a weakening of this resolve their negative reaction would be swift and unmistakable. As a bulwark against the potential corrosive effects of inflation the flexibility given to the U.S. economy as a result of the presence of this fund should be a jealously protected condition.

Thus, the structure set in place for social security is a new factor to be reckoned with in the evaluation of the prospects for the U.S. economy with major positive implications. Because of this potential significance, we at Dreyfus feel strongly that it must be protected not only for its meaning to the present participants in social security but also because of its broad meaning for the economy generally. We anticipate that this fund will become an increasingly important factor in influencing the environment critical to the plans and programs of business and individuals. Its potential positive effects should not in any way be diluted or diverted. What has been created is a major and growing pool of money with broad significance to the well-being of the U.S. economy and its ability to lead to a higher standard of living for the future.

Written By: Monte J. Gordon
Vice President &
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Testimony by

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and

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before the

Subcommittee on Social Security and Family Policy

U.S. Senate Committee on Finance

June 30, 1988

Mr. Chairman, we appreciate the opportunity to testify before the Subcommittee on Social Security and Family Policy, Committee on Finance, on the implications for the securities markets of the projected Social Security trust fund surpluses.

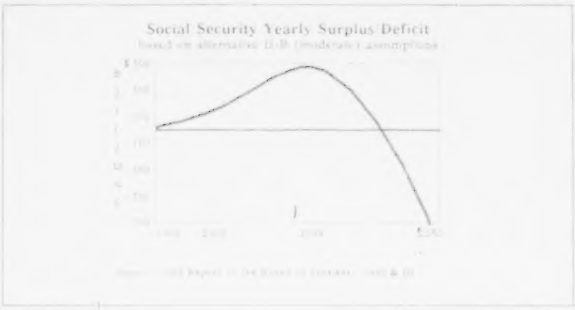
The Social Security program is structured to accumulate surpluses in the decades ahead to defray huge benefit payouts that will begin in the second decade of the next century, when the first of the 73 million baby boomers born between the late 1940s and the early 1960s retires.

Do the projected Social Security trust fund surpluses of the future affect stock and bond prices now?

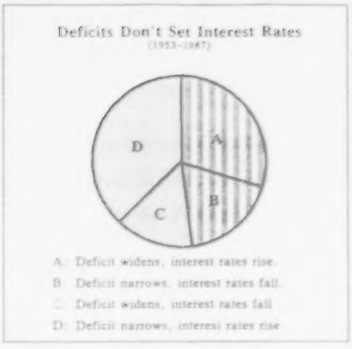
The annual surplus is small now, $21.9 billion in 1987, but is projected to be mammoth in the mid-1990s and into the new century. Social Security surpluses are invested in special (nonmarketable) Treasury securities, thus effectively reducing the amount of the budget deficit that must be financed through the sale of marketable securities to the public.

Under the moderately optimistic alternative of four assumptions developed by the Social Security Administration, the yearly surpluses would grow steadily to a peak of $483 billion by 2015 when trust fund assets would equal 5½ years of benefit obligations. After 2015 fund assets would continue to rise, but at a slower pace, until 2030 when they would reach $11.8 trillion. It is projected to take only 18 years after 2030 to exhaust the $11.8 trillion war-chest.

Although the projected surpluses (should they actually survive Congress and the inevitable surprises in the economy) are awesome to our sensibilities, they would be substantial even in the 2030 environment when nominal GNP by the same projections would be $54 trillion and last year's Federal deficit would translate to about $2 trillion.

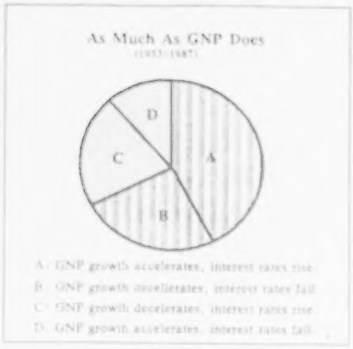


Only time will tell whether the Social Security surplus ever materializes—or, like the "peace dividend" from ending the Vietnam War—is overtaken by other, more urgent, budget priorities. Knowing the outcome in advance wouldn't tell much about interest rates anyway. For interest rates are *not* set by the budget deficit in isolation. The federal budget has swung toward a larger deficit as a share of GNP in 17 years since the Korean War ended and interest rates were unpegged. In 7 of those years interest rates fell, and in 10 years they rose. The budget swung toward a smaller deficit in the other 17 of the last 34 years, with interest rates rising 12 times and falling 5. What made the difference for interest rates was how well the economy was doing and what the Fed was trying to accomplish with monetary policy.



Fiscal policy affects financial conditions indirectly, through the influence of the budget on economic activity. Last year provided a graphic illustration. From 1986 to 1987, the federal budget deficit narrowed from $220 billion to $150 billion—$70 billion, one-third of the deficit, 1.6% of GNP. (The Social Security trust fund contributed $3 billion of the overall deficit shrinkage.) But a resurgent economy and tighter Fed policy contributed to a 300 basis point run-up in interest rates just the same.

GNP has a more reliable, though still imperfect, track record in determining interest rates. When GNP growth accelerates, interest rates tend to rise; when growth subsides so do interest rates.


As Much As GNP Does
(1953–1987)
D
A
C
B
A - GNP growth accelerates, interest rates rise
B - GNP growth decelerates, interest rates fall
C - GNP growth decelerates, interest rates rise
D - GNP growth accelerates, interest rates fall

Interest rates and GNP growth rates move in the same direction about two-thirds of the time. When they don't, there is often a policy reason, such as the restrictive Fed policies in 1969–70 and 1979–80 which upped interest rates to slow nominal GNP growth and restrain inflation. Conversely, interest rates averaged lower in 1976 and 1983 while Fed policy was aimed at supporting the lift in economic activity that occurred in those years.

Social Security trust fund assets at their peak would represent about 22% of GNP. In today's world, a similar hoard would translate to slightly over $1 trillion. At the end of the first quarter of this year, total marketable Treasury debt outstanding amounted to $1⅞ trillion. An additional $⅝ trillion was already borrowed from various government trust funds, including the Social Security trust fund. No one can say for certain what the level of interest rates would be if borrowings from the trust funds were at zero and borrowings from the public were $⅞ trillion higher. In all likelihood—if GNP growth, the split of GNP between consumption and exports and capital expenditure, inflation, foreign exchange market conditions were all unaffected—the level of interest rates would be no different than what exists currently.

A reduction in the supply of Treasury securities, however, should this occur, would cause the widening of spreads between the yields on Treasury securities and the yields on mortgages, corporate bonds, and other types of debt securities. It is, however, questionable if there ever will be any meaningful reduction in the supply of Treasury securities. Even if the Social Security surpluses accumulate as projected, the supply of Treasury securities will continue to grow unless the deficit in the rest of the federal budget shrinks severely. The deficit in 1987 in the non-Social Security part of the budget corresponds to 3.8% of GNP. If the deficit is maintained at the current percentage of total output until the year 2000, and if the entire Social Security trust fund were used to offset the deficit, there still would be nearly $4 trillion of marketable Treasury securities outstanding. Qualitatively, the same result holds in the subsequent decades as well. That is unless the non-Social Security portion of the deficit shrinks as a percent of GNP, the absolute volume of Treasury debt in the marketplace continues to grow. Ten years ago the marketable debt represented 21% of GNP. Today it equals 38%. If the deficit were to grow at the same rate as GNP until 2000 (assuming no nonmarketable borrowing), the marketable debt then would correspond to 52% of the GNP. With the growth of the Social Security trust fund surplus, the Treasury marketable debt can remain at the same percentage of GNP at the turn of the century that it is today.

Long-term yields are likely to rise and fall hundreds of basis points—several times—between now and when the Social Security trust fund is scheduled to peak in 2030. Interest rate fluctuations will depend in the future on the performance of the economy and the Federal Reserve's posture, just as always. The budget deficit and the Social Security program will affect interest rates and security prices only insofar as they affect macroeconomic developments.

-3-

The projected trust fund surpluses, of course, depend on assumptions about economic conditions and interest rates, birth rates, life expectancy, immigration flows, retirement preferences and the like for decades into the future. Social Security's tax take is geared to wages and, as the tax is regressive, especially to lower-end wages. Benefit payouts, however, are geared to consumer prices. Part of the projected surplus is based on the assumptions that wage rates will be rising faster than prices and that the differential will be greater on average during the coming 30 years than over the past 30.

It may be that the greater risk to the trust fund surpluses comes not so much from unreasonable optimism about the future but funding deficits in the rest of the budget with surpluses in Social Security will become a compelling political expedient in tax-averse debtor America.

Even if there develops no public outcry against using the trust fund surpluses to offset deficit spending elsewhere in the federal government sector, a public policy question still arises when funds accumulated through a regressive payroll tax are used to finance current government outlays on a wide range of consumption and investment activities. In most people's understanding, the fiscal compact in the U.S. calls for financing general government expenditures through a progressive income tax.

The flow of goods and services baby boomers will consume in retirement beginning several decades hence will have to come out of the economy's production *then*. The only way to save for that flow *now* is to invest in physical and human capital that will increase the economy's subsequent productive capacity. A Social Security trust fund surplus will be constructive in this regard only if other policies—fiscal, monetary and regulatory—encourage investment versus consumption in the 1990s and beyond.

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OPENING REMARKS TO HEARINGS
SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY
COMMITTEE ON FINANCE
UNITED STATES SENATE

June 30, 1988

DONALD G M COXE
MANAGING DIRECTOR & CHIEF PORTFOLIO STRATEGIST

I appreciate Senator Moynihan's invitation to appear today to make some observations about the important economic and financial potential of the Social Security Trust Fund. In particular, I have been asked to comment on the relevance for the United States of the experience Canada has gained in its more than two decades of operating a somewhat similar program under the Canada Pension Plan.

Given that mandate, it might be useful to begin by outlining some relevant items of my background.

I am a Canadian who moved to this city a year ago to take on responsibility of Chief Portfolio Strategist for an investment firm. Previously, I was Research Director for a Canadian institutional investment dealer.

My experience in Canadian public policy development comes from two years as General Counsel to the Ontario Federation of Agriculture and six years on the Canada Pension Plan Advisory Committee, which advises the Minister of National Health and Welfare on pension policy. Thereafter, I spent four years as one of the members of the Royal Commission on Pensions.

I have also been a commentator on Canadian public policy as correspondent for National Review and as Contributing Editor to Canadian Business, Canada's leading business journal.

When the United States, under leadership from Senators Moynihan and Dole, chose to convert Social Security from a totally pay-as-you-go system to a partly-funded plan, this country embarked on a program that has major similarities to the Canada Pension Plan.

That Plan, inaugurated in 1966, pays retirement, disability, and death benefits from a trust fund financed by employer/employee contributions. The statistics I shall quote are from the Canada Plan, known as the CPP. Residents of Quebec participate in that province's own plan, which pays identical retirement benefits to those provided under CPP. That we have two plans in Canada reflects the constitutional division of powers between the federal and provincial governments, which can make achievement of national consensus on social programs difficult at times. When talking of the government contributory pension plan, Canadians often refer to it as "CPP/QPP", making two separate, but parallel, programs sound like one.

When the CPP began in 1966, the trust fund didn't look to be an important feature of the program. Since the fund invested in long-term bonds issued by the provinces,--not the the federal government--it was an unobtrusive component of Canadian capital markets.

Within a few years, CPP/QPP became the backbone of provincial government financing in Canada. Under the Canadian constitution, the provinces have responsibility for such major programs as education, including universities, and medical care, which in

Canada is entirely government-run. Since demand for such services routinely outruns taxpayers' willingness to pay for them, (a phenomenon not unknown in the United States), and because federal and provincial governments in Canada routinely promise more than they can afford to deliver, (a contagion historically difficult to contain at the 49th parallel), fiscal deficits across Canada have been endless, awesome, and at times, terrifying. Since the Mulroney government took over in Ottawa, some semblance of restraint has been shown there, but the provinces still spend on a scale which makes the oft-criticized-Congress seem parsimonious by comparison. Combined federal/provincial deficits in relation to GNP in Canada have run far above American governmental deficits for more than 15 years.

One major reason why Canadian governments have been able to spend so freely is the huge buildup of funds in the Canada and Quebec Plans. The CPP alone has a hoard of $33.7 billion. To put that sum into perspective if the Social Security Trust Fund were similarly funded on a population basis here, the fund would have at least $400 billion in the kitty.

What the CPP did, in its first 15 years, was to take the provinces out of the long-term bond market. Since the Fund buys non-marketable 20-year bonds issued directly, without commissions, to the Minister of Finance, the provinces have an open spigot. They used these moneys during the first ten years of the Plan mostly

to build hospitals and universities. Now they need the moneys to finance the operations of those hospitals and universities.

Because the CPP constitutes forced saving by the workforce, it has been, since its inception, a significant part of overall national savings. The personal savings rate in Canada has tended to average about twice to three times the American savings rate, and the CPP/QPP in its early years represented as much as one-quarter of total Canadian personal savings. (Its role declined in this decade because the contribution rate remained fixed even as benefits rose; a new , much higher, contribution rate is now in effect, and one can assume that CPP/QPP will once again be a major contributor to overall savings.

Without the Plan, it is highly unlikely that the Canadian dollar could have survived the economic and political problems of the early 1980s without collapsing, perhaps as far as the 50 cents US range many commentators had publicly predicted for the beleaguered currency.

Why?

Because Canada has at all times been dependent on importing foreign capital. In part this dependence arose from the sheer cost of operating an economy strung out along the American border: in part it arose because of the Canadian economy's emphasis on resource development: it costs far more to

create a job in mining than, for example, in manufacturing. In significant part, though, it reflects Canadians' historical reliance on governmental involvement in the economy and their preference for generous social programs.

As long as foreign investors were willing to pour huge sums into the purchase of Canadian bonds and stocks, those Canadian financing needs didn't lead to worrisome problems in financing the nation's continually-growing external debt. In particular, rising prices during the 1970s for most commodities, --and particularly for oil and gas--attracted foreign capital so easily that most internal political discussion on the issue was confined to controlling its inflow. That the main attraction for foreign investors was Canadian resources, not Canadian political and social arrangements, was obscured by the prospects of endless inflation.

A nation that finances its own economy and government is able to set, to a major extent, the prices of its own bonds and stocks.

A nation dependent on capital imports to finance its economy and government must, to a major extent, let foreigners set the prices of its bonds and stocks.

Since only a few Canadian provinces had the kind of credit ratings which would permit them to issue long-term debt month-in, month-out in world capital markets, the CPP was a godsend because it allowed the provinces to finance their deficits at

home without disrupting Canadian public debt markets.

With the provinces able to finance their fiscal deficits overwhelmingly from the CPP during the 1970s, the federal government, embarked on ambitious adventurism, found that the nation's long-term public debt market was left open for Ottawa, almost regardless of the level of national deficits.

In 1980, the inflationary bubble burst, and the nation faced its most serious economic crisis since the Depression. Its situation was ar more perilous than this country's because :

First, the country's dependence on commodity prices was much greater;

Second, its external debt was enormous, whereas the US was then still a net creditor on international account, and

Third, its fiscal deficits going into the recession were huge, giving governments little maneuvering room.

Without CPP, it's hard to see how Canada would have pulled through the recession and high interest rates of the 1981-83 period, when governmental deficits exploded, commodity prices tumbled, and the currency stumbled. By giving the overstressed provinces ready financing at a time when long-term funds were almost unobtainable, the CPP performed a function its founders could hardly have visualized.

Comment

What is the usefulness of the Canadian experience for Americans?

Without presuming to intrude on American decisionmaking, a Canadian could note the following:

1. The US is now as dependent on imports of foreign capital as Canada was in 1980.

Now that the US has a current account deficit of about $160 billion a year and about $500 billion in net external debt, this nation must also consider how it can stabilize its government debt markets without counting on the continued willingness of foreigners to finance government deficits.

In particular, as the events of last September and October showed so painfully, if foreign investors turn negative on the outlook for the American dollar, not even concerted intervention by the world's central banks can prevent huge runups in American long-term interest rates, a powerfully destabilizing situation. The Federal Reserve can moderate escalations in short and medium-term rates, but as long as the Treasury needs continued votes of confidence from foreigners to sustain the long-term bond market, the economy is at risk. It is impossible to visualize, for example, a healthy mortgage market without a healthy market for long-term Treasuries.

2. The CPP has never held short-term securities, an

investment philosophy which is eminently sensible for a pension fund, and which also tends to maximize investment income. How important is that? Well, during the current year, the CPP has received $5.58 billion in contributions, while earning $3.48 billion on investment income. Total benefits were $7.36 billion, which implies that 47% of the cost of the benefits has come from portfolio earnings. The typical private, fully-funded, pension plan assumes that about two-thirds of the cost of benefits come from interest income; social insurance cannot expect a similar proportion of cost coverage, but the more interest is earned, the more secure future benefits will be.

3. One conspicuously successful aspect of CPP has been its actuarial forecasting. This is worth noting, because the life insurance industry in Canada fought a demeaning, and ultimately self-defeating, war against CPP in the early 1960s; the industry sought to scare Canadians by attacking the actuarial soundness of the Plan, arguing that it would go bankrupt. Rarely has Canadian business behaved more irresponsibly, and it has taken decades of successful operation of the plan to convince many gullible Canadians that the plan's promises would be kept.

One reason why the actuarial work has been so effective is that the CPP has always held long-term bonds. This has made prediction of interest income on a longer-term basis quite feasible, just as it is for private pension plans.

If the Social Security Trust Fund were to use its cash flow to buy only long-term Treasuries, this nation would get the same kind of excellent results as Canada achieved from the CPP's investment program.

The only losers in Canada from giving the provinces long-term funding through CPP were investment dealers, who lost the underwriting commissions they would otherwise have earned. (Underwriters ordinarily get higher spreads from long-term financing than short-term.) Those savings have been enormous. I see no reason why American taxpayers should not reap similar savings by using the Social Security Trust Fund as the sole vehicle for long-term Treasury financing, with commensurate benefits for domestic bond and mortgage markets.

4. One negative result of the CPP that Americans should consider is that forced saving giving easy financing to governments may make spending restraint almost impossible. If one's problem is alcoholism, an unending supply of cheap liquor is unlikely to foster personal discipline.

Whilst admitting that negative aspect of CPP,--and, by implication, for the Social Security Trust Fund--I don't think it should be overemphasized. On balance, partial prefunding of public pensions has been a resounding success for Canada, and will surely be so in this country.

Finally, I think that the longer-term implications for the American dollar of the Social Security Trust Fund are most favourable in the light of the Canadian experience. By taking the provinces virtually out of the long-term bond market except for financing their provincial utilities, the CPP helped the Canadian dollar through some financial white water.

Only a Panglossian optimist would assume that America will never need that kind of bond market stabilizer during the next few years.

I thank the subcommittee for this opportunity and look forward to questions.